SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 1185

FREDERICK J. PAGNANI,

Petitioner,

—against—

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on December 23, 1968.

Citations to Opinions Below

The opinion of the United States District Court, Honorable Sylvester J. Ryan, U.S.D.J. (R. 1472),* printed in Appendix B hereto, pages 66-88, is reported at 259 F. Supp. 99. The opinion of the United States Court of Appeals for the Second Circuit, printed in Appendix B hereto, pages B1 *et seq.*, is not yet reported.

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* Citations to "(R.)" are to the Record in the Court of Appeals.

Jurisdiction

The judgment of the Court of Appeals was entered on December 23, 1968, Appendix B, pages B1 *et seq., infra.* The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

Whether an attorney representing a seller, after disclosure to the buyer of the fact that the attorney is receiving compensation in the form of a beneficial interest in the proceeds, must, in order to prevent such disclosure from being misleading within the meaning of Rule 10(b)-5, further disclose as a "material fact", the exact amount of such compensation.

Whether an attorney representing a seller, after disclosure to the buyer of the identities of all persons having a beneficial interest in the proceeds, must, in order to prevent such disclosure from being misleading within the meaning of Rule 10(b)-5, further disclose as a material fact the exact allocation of the proceeds among such persons, even when the consideration received by the buyer is admittedly adequate.

Whether an attorney representing a seller, who receives a percentage of the proceeds as compensation for his legal services, commits common law fraud by failing to disclose the exact amount of his fee to the buyer, after it has been disclosed that he has a beneficial interest, when the consideration received by the buyer is admittedly adequate.

Whether an attorney representing a seller must disclose to the buyer the exact allocation of the proceeds among the sellers, even when (a) the information thereby disclosed

has been communicated to the attorney in confidence by his clients, (b) the consideration received by the buyer is admittedly adequate, and (c) the buyer, having been informed of the identities of all persons having beneficial interests in the proceeds, does not inquire as to the allocation among such persons.

Whether, if Rule 10(b)-5 is now construed to make unlawful the failure of a seller's attorney to disclose that he is entitled to one-sixth of the sale proceeds under a pre-existing contingent fee agreement with seller, after it has been disclosed to buyer that he has a beneficial interest, such a construction of the Rule is invalid under the Fifth Amendment for failure to provide an ascertainable standard of conduct.

Whether the Court of Appeals, in issuing an injunction upon a record which the Court itself characterized as disorganized and inadequate, where the Court indicated in its opinion that it would condemn such a record in all future cases brought by Respondent, so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision.

Whether the Court below so far departed from the accepted and usual course of judicial proceedings in issuing a vague and sweeping injunction restraining petitioner for some unspecified time from, directly or indirectly, by the use of the means or instrumentalities of interstate commerce, the mails or the facilities of any national securities exchange,

(1) engaging in any devices, schemes or artifices to defraud or in any act, practice or course of business which operates or would operate as a fraud

or deceit upon any person in connection with the purchase or sale of any security of GAI, including acts, practices or a course of business of the type described in Count One of the Complaint;

(2) making any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of securities of GAI, including the type of misstatements and omissions described in Count One of the Complaint

as to call for an exercise of this Court's power of supervision.

Statutes Involved

The statutory provisions involved are Section 10(b) of the Securities Exchange Act of 1934, as amended (15 USC 78j(b), and Rule 10(b)-5 (17 C.F.R. 240.10b-5) promulgated thereunder.

Statement

The complaint was filed on or about June 16, 1966 (R. 1). The jurisdiction of the District Court was invoked under Section 27 of the Securities and Exchange Act of 1934 as amended, 15 U.S.C. 78aa.

This action involves the acquisition or attempted acquisition by Great American Industries, Inc. (hereinafter referred to as "GAI") of mining interests in California, Arizona and Nevada. Counts Two to Six of Respondent's complaint made no charges against Petitioner Frederick J. Pagnani (hereinafter "Petitioner" or "Pagnani"). Count

one of the complaint first asserted that, known to certain specified individual defendants but unknown to GAI and its stockholders, Petitioner received or was to receive stock in connection with the proposed acquisition by GAI of the Arizona and Nevada properties, although, according to respondent, Petitioner contributed no property or services of any economic value other than the services allegedly rendered as a "finder" (R. 6). Count One further alleged that Petitioner took steps to conceal from GAI and its stockholders the original arrangements relative to the Nevada transaction by entering into new arrangements (R. 12). Petitioner denied generally the material allegations of the complaint and filed an affidavit responding to the charges against him (R. 1186; 1400-13).

Petitioner was not involved in the abortive California transaction, nor did he have anything to do with any press releases or 8-K reports concerning the Arizona and Nevada properties for which certain corporate defendants were held liable.

Petitioner is a practicing attorney in New York (R. 1400, Pagnani Aff.). A Mr. Matusow came to him in early March 1966, advised him that Matusow had become associated with a Mr. Beard in a joint venture to develop Beard's mining interest, and requested that Petitioner render the legal services that would be required from time to time by the joint venture. They reached agreement that Petitioner would perform such services on a contingent basis, receiving a one-sixth interest in the proceeds of joint venture (R. 1404-05, Pagnani Aff.).

Matusow then negotiated the sale of Beard's Arizona property to GAI. Petitioner had no part in these negoti-

ations and did not even know they were pending until Matusow told him that the terms had been agreed upon. Petitioner then performed the legal services needed to complete the transaction.

The transaction involved a contract between Beard and GAI for the sale by Beard to GAI of the stock of the company owning the properties in return for stock of GAI. Pursuant to his one-sixth interest in the proceeds of the joint venture, Petitioner received, for the legal services he rendered, one-sixth of the 200,000 shares representing the purchase price. Beard's agreement with GAI expressly stated, in Paragraphs First and Second A, that persons in addition to Mr. Beard, not more than ten in number, had a beneficial interest in the stock of the company owning the properties (R. 1403, 1406-1408, Pagnani Aff.). It is this transaction alone for which the Court below issued an injunction against Petitioner. Petitioner asserted in his affidavit that Matusow told Marren, Financial Vice President of GAI, in Petitioner's presence, that Petitioner and he had an interest in the transaction (R. 1407, Pagnani Aff.), and the Court below has so found.

The Nevada properties first came to the attention of Petitioner in April 1966 when Matusow told him that he had received a call about them from Beard, who thought they were valuable. Matusow and Petitioner went west to review the situation with Beard. Matusow telephoned Mack, the GAI Chairman in New York, told him of the availability of the property, and asked whether he was interested in acquiring it for GAI (R. 1407-1408).

Mack went to Nevada and negotiated for the acquisition of the property. When the parties had agreed in principle on the terms, Petitioner participated in the necessary legal

work. The contract provided expressly on its face that 134,000 shares were to be issued to Matusow, and 33,000 shares apiece to Pagnani and Beard in accordance with their four-sixths and one-sixth respective interests in the proceeds of the joint venture (R. 1408-09, Pagnani Aff.). It was dated April 22, 1966. The closing did not take place then, for the suspension of trading in the stock of GAI took place and also because litigation arose relative to the property (R. 1410, Pagnani Aff.). Subsequently, the contract was renegotiated to provide for indemnifications by certain parties to GAI with respect to the litigation, the assumption by certain parties of certain exploration costs and the issue of a total of 45,000 shares to Petitioner, Beard and Matusow which were to be divided equally between them, since Beard and Matusow had renegotiated their joint venture, as well as their arrangement with Petitioner as to legal fees. The shares to be received by each is expressly stated in the contract (R. 1410-13, Pagnani Aff.). It is this renegotiation which the Commission called an attempt to "conceal" the original arrangement (R. 12, Complaint).

There is no evidence in the record, and nothing in either the decision of the District Court or that of the Court of Appeals, controverting in any material respect Petitioner's statements in his affidavit as to the manner in which he became associated with the Arizona transactions, or the role he played. Petitioner acted solely as an attorney for members of a joint venture, and he received in return therefor, as a contingent fee, a percentage of any sale proceeds realized by the joint venture.

The opinion of Judge Ryan in the District Court, insofar as it relates to the charges concerning Petitioner, made the

following findings: (1) The officers of GAI probably knew that others besides Beard were to receive some of the shares being issued by GAI in the Arizona transaction (R. 1487-89 Op.); (2) "Beard, [Petitioner] and Matusow had a joint venture agreement providing for their share in mining properties owned or controlled by Beard; Matusow to contribute sales services and [Petitioner] his legal services to a ratio of 4/6 for Matusow and 1/6 and 1/6 each to the other two, Beard and [Petitioner]" (R. 1489, Op.); (3) The officers of GAI "knew [Petitioner] as Beard's attorney. They undoubtedly knew that Matusow and [Petitioner] were to be compensated by Beard" (R. 1489, Op.); (4) "After an inspection by Mack and his mining expert Behre [of the Nevada property], and a favorable report on it recommending exploratory drilling [Petitioner], under his joint venture agreement with Beard and Matusow, drew the sales contract [for the Nevada property] between GAI, as purchaser, and Pacific Sulphur Company, as seller." The contract provided for the issue "of 200,000 shares to Matusow and [Petitioner] and Beard (4/6, 1/6 and 1/6 according to their agreement)" (R. 1491, 1492, Op.); (5) "The closing scheduled for April 20, 1966 never took place because of the trading suspension and also because in the meantime a lawsuit had been started by one claimant that it had a contract of purchase with Crofoot. After further negotiations, on June 3, 1966, a new agreement was drawn providing for the same price of 300,000 shares of GAI stock, but to be differently apportioned—Matusow, Beard and [Petitioner] to receive 15,000 shares each, and the balance to go to Crofoot to increase its allocation to 44,232 shares and Canyon and Commonwealth to 105,384 shares each" (R. 1492, Op.); (6) "The charge that

the Nevada agreement was redrawn in order to conceal the fraud on GAI falls by reason of our finding that there was no fraud and also of its own weight. If defendants were out to fraudulently induce GAI to issue its shares, as is charged, a change in the reallocation of the same number of shares would still be a rather obvious fraud. Perhaps the investigation did make defendants take a harder look at their bargain, but this would not be evidence of consciousness of guilt. Besides, the Commission has not disputed the reasons advanced by all defendants for the revision of this agreement'' (R. 1496, Op.).

The court also found that Respondent had failed to establish that the facts allegedly concealed were material facts which would have influenced GAI in its decision to issue the stock. On the basis of the foregoing the District Court refused to issue a temporary injunction against Petitioner.

The Court of Appeals reversed and issued an injunction of uncertain scope and unspecified duration against Petitioner. The court found that Petitioner had been present at the closing of the Arizona property; that purchaser's Vice President has asked Petitioner's client who else had a beneficial interest in the stock of the seller; and that the client had disclosed Petitioner's name and the fact of his beneficial interest but not his exact share. (Appendix, p. B17) The court found also that Petitioner did not come forward at that point and explain the exact nature of his financial relationship to his client, or the financial relationship of his client to the deal, and that failure to do so was common law fraud because it was necessary to keep the statement that he had a beneficial interest from being misleading (Appendix, p. B18).

Reasons for Granting the Writ

1. The holding of the Court of Appeals that the fact an attorney is entitled to one-sixth of the sale proceeds under a pre-existing contingent fee agreement with seller is a material fact which must be disclosed to purchaser—even when the adequacy of the consideration received by said purchaser is unquestioned—raises an important issue hitherto undecided by this Court, which should be resolved by it in order to remove the cloud of uncertainty which now hangs over every acquisition for stock of the acquiring company.

The Court of Appeals acknowledged (Appendix, p. B14) that its view of materiality has undergone revision since *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 366 F.2d 456, 459 (2d Cir. 1966), having been "further developed" in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). The instant case expands the concept of materiality still further, and in a manner which is internally inconsistent. The trial court found that since Respondent conceded that it was not questioning the value of the properties acquired in exchange for the shares issued, the court had to assume that the consideration was adequate—irrespective of who was to receive it. The failure to disclose the allocation was *not* a failure to disclose the true purchase price demanded by sellers. The true purchase price of the property is the material fact involved, not how that price will later be allocated. The trial court, it is submitted, was entirely correct. And at one point the majority of the Court of Appeals recognizes this fact, saying that the trial judge may still have been within the bonds of allowable discretion in holding that no sufficient case for issuing an injunction had been

made if the episode of the distribution of the shares stood alone, citing *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* but that coupled with consideration of the misleading reports and releases there were sufficient grounds to issue an injunction against the corporate defendants (Appendix, p. B15). Yet all *Petitioner* is charged with is failure to disclose the distribution of the shares, so that upon the Court of Appeals' own holding with reference to materiality the District Court should have been upheld as to Petitioner.

The difficulty with the court's view of materiality is pinpointed by consideration of the following:

> (1) The court below held that the buyer did not have a duty to inquire into the identity of persons who had a beneficial interest in the stock being purchased; and
>
> (2) The court below held that seller, his joint venturer and his attorney did not have an affirmative duty to disclose the identity of persons who had a beneficial interest in the stock being purchased.

Based on the foregoing, how could Petitioner possibly know that the court would find that his financial relationship to seller was material? How can anyone ever know when anything will be considered material in light of rulings such as these?

The decision below presents an issue not previously decided by this Court, and one which should be resolved in order to establish a definition of what is material with regard to sellers' plan for allocation of the proceeds of sale which may be followed by sellers, their agents and attorneys in future cases involving acquisitions for stock.

2. The position taken by the Court of Appeals, that Petitioner committed common-law fraud by not disclosing his

exact financial relationship to seller when questioned by buyer, is plainly wrong on the facts of the action; it is in conflict with a decision of the Third Circuit Court of Appeals in *First Trust & Savings Bank* v. *Fidelity-Philadelphia Trust Co.*, 214 F.2d 320 (3d Cir. 1954);* and it presents the likelihood of chaos in the future administration of the securities laws.

Briefly, the court below found that Petitioner acquiesced in a partial statement made by his client and that he failed to disclose additional facts which would prevent his client's partial statement from being misleading. When an officer of GAI asked who besides Mr. Beard had a beneficial interest in the stock GAI was buying, Mr. Matusow replied that he and Petitioner did. Petitioner acquiesced in this statement, also believing that buyer knew he was acting as attorney for Messrs. Beard and Matusow. Petitioner never misled anyone. He was called upon to disclose the *fact* of his interest, not the *extent* of it. He did so, thereby placing purchaser on notice as to his interest. The court below has held that buyer need inquire no further, because it refused to impose liability on the corporate defendant for the Arizona transaction. If buyer need go no further, seller and his attorney should not have to do so either.

The Third Circuit has held in *First Trust & Savings Bank* v. *Fidelity Philadelphia Trust Co.*, 214 F.2d 320 (3rd Cir. 1954), that similar facts to those stated above do not constitute common law fraud. There plaintiff First Trust sued defendant bank for loss when it was discovered that certain liquor warehouse certificates held for security on notes purchased and deposited for safekeeping with defendant and forwarded by defendant to plaintiff were spurious. The

* Reprinted as Appendix C hereto.

credit manager of defendant had responded by letter to an inquiry by plaintiff concerning the credit of the maker of the notes and certificates found to be spurious. The Third Circuit found in discussing this letter:

> "There is more to be said about the letter however. It went on to say that PAC's account was handled in a satisfactory way and gave an explicit statement about an average five-figure balance. This five-figure statement was true but it was also found as a fact that twelve times in the two months before the letter was written, PAC had had overdrafts amounting to sums from several hundred dollars. We do not go with the argument that when a man says something that is literally true he has told the truth even though he does not tell the other things which would qualify the statement made. 'To tell half a truth only is to conceal the other half.' But the saving grace of the letter is the last sentence. The defendant's credit manager said: 'A condensed balance sheet exhibited to us last year indicates that the net worth of the Philadelphia Acceptance Corporation is limited and is substantially less than outstanding obligations.' That, we think, is enough. The sum total impression from the letter is truthful and certainly gives warning to one who is prospectively going to extend credit to the concern inquired about." (Appendix C, (pp. 9-10.)

The instant situation is similar in all material respects. Petitioner, through Mr. Matusow, was truthful in the answer he gave to lawyer and certainly gave warning to GAI, the purchaser, of the fact that others had a beneficial interest in the deal. The holding in *First Trust* that there was no common law fraud is directly contrary to the result in this action.

The decision below, if left undisturbed, will wreak havoc with the affairs of the business community and also with administration of the securities laws. It will do away completely with the selling "undisclosed principal" who is to receive stock of the purchaser, because the agent or attorney for said principal will have to disclose the nature and interest of his principal or principals or run the risk of violating the majority opinion below. No attorney would have any idea when the nature of his contingent fee arrangement with seller would become a material fact which he would have to disclose. Would it be when that interest was in one-sixth of the proceeds of sale, as was the case with Petitioner here? That is the seeming basis for holding Petitioner liable, but the court relies heavily on the failure to disclose the fact that 5/6 of the consideration was going to other than the announced seller. Perhaps then Petitioner would not have violated Rule 10(b)-5 if his was the only interest other than that of the announced seller and if it had not been disclosed. The doubt now cast over such transactions will lead to nothing but confusion in regulating such transactions, and it will be confusion on a grand scale when the number of acquisitions for stock taking place every day is considered. This court should decide the important question raised by the Court of Appeals' expansion of the doctrine of common law fraud as it relates to sellers, their agents and attorneys.

3. The effect of the holding below is to establish that an attorney, who renders professional services to a client in connection with a sale of securities, is required to disclose to the adverse party all of his client's business arrangements with respect to the distribution of the proceeds, even where such information has been communicated to him in

confidence. We submit that there is no basis in this statute for such an extraordinary result.

If the attorney-client privilege is abrogated in this respect, the seller will in effect be denied any effective assistance of counsel, a result fundamentally contrary to public policy and entirely unnecessary for the enforcement of the securities laws. *Cf. Securities and Exchange Commission* v. *Higachi,* 359 F. 2d 550, 553 (9th Cir. 1966).

Moreover, the duty imposed upon the attorney by the holding below has no readily ascertainable limits. If the attorney must disclose the terms of a joint venture agreement, in violation of the client's confidence, must he also disclose any other contractual arrangement pertaining to the proceeds? Must he disclose that the client has assigned the proceeds to satisfy a promissory note given in an unrelated transaction? Or that the client has assigned the proceeds to a former wife in satisfaction of back alimony?

Even if the attorney violates the client's confidence to the extent of disclosing such facts, he may still be subject to liability under the holding below: in this case the identities of all parties with a beneficial interest *were* disclosed, and the disclosure was held to be "misleading" because amounts were not specified. Under the holding of the Court of Appeals, an attorney must in effect volunteer a complete and gratuitous disclosure of all his client's confidential business affairs, or face potential liability of an uncertain extent for having disclosed either too much or too little.

Even if information as to the distribution of proceeds were otherwise material, it could equally well have been

sought, and obtained, from the client himself. Nevertheless, the Court of Appeals proceeded to impose upon the seller's attorney an affirmative duty to inform the purchaser of the seller's private business arrangements, even where this would clearly involve a direct breach of the confidential relationship. The imposition of such a burden upon the attorney is clearly inconsistent with that "undivided allegiance" to the client referred to in *Von Moltke* v. *Gillies*, 332 U.S. 708, 725-6 (1948). These drastic inroads upon the attorney-client privilege, imposed without any explicit basis in the statute, represent a severe departure from existing law, and present grave questions which should be reviewed by this Court.

4. It is a fundamental principle of constitutional law that an administrative rule or regulation imposing civil or criminal liability must provide some readily ascertainable standard of conduct so that those subject to the law might determine what they are proscribed from doing. *In Re Ruffalo*, 390 U.S. 544 (1968); *Whitehill* v. *Elkins*, 389 U.S. 54 (1967); *Keyishian* v. *Board of Regents*, 385 U.S. 589 (1967); *Bantam Books, Inc.* v. *Sullivan*, 372 U.S. 58, 71 (1963); *Winters* v. *New York*, 333 U.S. 507 (1948); *Kraus & Bros.* v. *United States*, 327 U.S. 614 (1946); *Lanzetta* v. *New Jersey*, 306 U.S. 451 (1939).

As this Court stated in *Kraus & Bros.* v. *United States*, *supra*:

> ". . . The dividing line between unlawful evasion and lawful action cannot be left to conjecture. The elements of evasive conduct should be so clearly expressed by the Administrator that the ordinary person can know in advance how to avoid an unlawful course of action." (327 U.S. at 621-22)

The principle set forth above is plainly applicable to this proceeding, for violation of Rule 10(b)-5 is clearly punishable by fine and imprisonment. See Section 32(a), 15 U.S.C. § 78ff(a).

The holding by the Court of Appeals that Rule 10(b)-5 applies to conduct on the part of an attorney for a seller, under the circumstances of this case, is clearly novel. The standard of conduct which the Court of Appeals has thus read into Rule 10(b)-5 is not one which a reasonable man could divine from either Section 10(b) or Rule 10(b)-5 and the court's retroactive application of the standard of conduct it enunciates to Petitioner violates his constitutional rights under the Fifth Amendment.

The Rule which it is charged petitioner violated was promulgated in 1942, based on Section 17 of the Securities Act of 1933. Petitioner has been unable to find any decision or rule since 1942 which even remotely deals with the conduct of an attorney in the instant situation. Without reliance on any prior decision the Court of Appeals has now enunciated the rule that a seller's attorney—not even an insider—has a duty to disclose the allocation of the consideration received when the percentage of the consideration to be allocated to other than the named seller exceeds some unspecified amount and some form of inquiry is made by purchaser. No commission rule or regulation has been cited by Respondent in this proceeding as governing expressly the situation presented herein and the Court of Appeals has indicated herein that they are loath to undertake the task of drawing distinctions according to the importance of the transaction between sellers of property and finders or between finders acting solely for such sellers and those having

some special relationship to an issuer. Thus the court below has in fact admitted that they have enunciated no ascertainable standard and, as the concurring opinion of Judge Waterman states (Appendix p. B20), the court is moving on a case by case basis without any attempt to formulate such a standard. Respondent has promulgated no guideline which would indicate to an attorney in a future action when he has violated the maxim set forth in the opinion of the court below. Petitioner only had a one-sixth interest in the proceeds of any sale by Mr. Beard. The court below places such great reliance on the fact that the so-called full truth was that five-sixths of the consideration was going to persons other than Beard that it may well be that the court is saying that Petitioner's interest, without the two-thirds interest of Mr. Matusow, would not have had to have been disclosed to Great American Industries. In any event, no attorney representing a seller can determine with any degree of certainty whether he should disclose his client's interest in a transaction if his client is not a party to the contract of sale and the attorney also has no idea whether he should disclose his interest in the transaction. It cannot reasonably be said that Rule 10(b)-5, as construed by the court below provides an ascertainable standard of conduct so "the ordinary person can know in advance how to avoid an unlawful course of action" (327 U.S. at 621-2).

5. Clearly, the question presented is of importance in the regulation and administration of the Federal Securities Laws. Indeed, the procedure followed in this action is one which may be employed again by Respondent to enforce an important provision of the Federal Securities Laws, Section 10(b) of the Securities Exchange Act of 1934, as

amended, (15 U.S.C. 78j(b)) and Rule 10(b)-5 (17 CFR 240.10b-5) promulgated thereunder. Respondent proceeds by filing a complaint and an affidavit paraphrasing the complaint and seeks on the basis thereof a temporary and permanent injunction. Again as was the case in the instant action, Respondent may paraphrase important exhibits and not annex them. In its unusual opinion, the Court of Appeals condemned this practice and yet on the basis of so-called evidence resulting therefrom issued an injunction against petitioner. The court in its opinion stated that the practice was defective and had been condemned in a case decided before that very court [*Securities and Exchange Commission* v. *Frank,* 388 F.2d 486, 490-92]. The Court of Appeals even noted that the District Court had complained that the documents were not quoted or presented and, that the District Court had to determine the degree of knowledge possessed by corporate officers—a critical issue in the case—without seeing or hearing those officers. The Court of Appeals also stated that the disorganized record handicapped it in considering the appeal, and went on to say:

> "* * * the district courts are not to accept the kind of moving affidavit that was offered here; the Commission has sufficient facilities to enable it to present documents in full text." (Appendix, p. B4)

Since the Court of Appeals enjoined Petitioner, the language quoted above could only be regarded as dictum. Furthermore, the language quoted above cannot purport to enjoin District Courts in other Circuits proceeding with decisions based on the affidavit practice of Respondent. The whole process of granting the extraordinary remedy of a temporary injunction on the basis of incomplete and inadequate documentation and without hearing witnesses when the is-

sues involved concern the knowledge possessed by those accused of wrongdoing is clearly improper. Furthermore, to enjoin Petitioner on the basis of a practice which the court interdicts District Courts from following in the future plainly violates Petitioner's right to equal protection of the laws and presents a situation where the Court of Appeals has so far departed from the accepted and usual course of judicial proceedings, as the Court of Appeals itself defines those proceedings in the *very same action,* as to call for an exercise of this Court's power of supervision.

6. The court below has decreed that an injunction be issued against Petitioner. The Court of Appeals did not specify the scope and duration of the injunction, although in the headnote they did refer to the remedy as a temporary injunction. They do not indicate, however, how temporary it is, and it might well be perpetual. The court also declined to state what Petitioner is enjoined from doing, beyond as Justice Moore points out, "violating the law with respect to stating facts or omitting to state facts regarding securities transactions." The Respondent, therefore, is free to use whatever hindsight it chooses to threaten Petitioner with contempt proceedings for anything it might be able to imagine. Clearly Petitioner should have some clearer standard of conduct against which to measure his action. Judge Moore in his dissent below emphasizes the onerous nature of the remedy chosen by the court when he states:

> "Pagnani is a lawyer. He performed legal services for Matusow and Beard. His fee arrangement with his clients was that his compensation was to be paid in stock (by agreement 1/6 of the shares received by them)—a not unusual arrangement between attorney and client. In complete violation of

the attorney-client privilege, the injunction would require Pagnani under penalty of court contempt to disclose all his fees in any transaction involving securities. But disclosure to whom? It would be presumptuous for GAI to ask, or demand to know, how much the seller was paying his attorney. Is a rule of law hereby being created that every attorney, under pain of committing 'common law fraud,' must reveal to the purchaser the amount of the fee he is receiving from his client, the seller? And lastly, how could the amount of a seller's legal fee possibly be material to those who choose to buy or sell the purchaser's stock? If the price of the purchase be fair (and it is not questioned here) for the commodity purchased, whether it be a mining property, cold rolled steel, or a trainload of grain, the legal fee paid by the seller to his attorney for drawing the contract not only is personal between attorney and client but would not even be an element which would affect the fairness of the transaction.

"Yet the majority, in effect, now tell Pagnani that they single him out as an attorney who henceforth accepts legal fees in stock at his peril unless he tells the buyer the amount of his fee and forces the buyer (how I do not know) to include it in an 8-K report. But why is stock different from cash? If the client received $600,000 and paid Pagnani $100,000, is Pagnani under a duty to exhibit his check to the buyer, examine the next 8-K report, and if it does not appear therein, advise the SEC that there has been an omission of a material fact? The buyer would undoubtedly take the position that the fee paid by the seller to his attorney was of no interest to him. Sufficient refutation of the majority's newly created legal theory should be found in a *reductio ad absurdum* approach." (Appendix B, pages 59-60, *supra.*)

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Constitutional and Statutory Provisions

FIFTH AMENDMENT TO THE CONSTITUTION OF THE UNITED STATES

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

15 U.S.C. § 78j(b)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. June 6, 1934, c. 404, § 10, 48 Stat. 891.

SEA Rule 10b-5, 17 C.F.R. 240.10b-5

EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Appendix A—Constitutional and Statutory Provisions

SEA Rule 10b-5, 17 C.F.R. §240.10b-5

Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

APPENDIX B

Opinions in the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 370—September Term, 1966.

(Argued March 22, 1967

Submitted to the *in banc* Court May 2, 1968

Decided December 23, 1968.)

Docket No. 31010

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

—v.—

GREAT AMERICAN INDUSTRIES, INC., WALTER S. MACK, JEROME MATUSOW, FREDERICK J. PAGNANI, WILLIAM THOMAS BEARD, EMANUEL LESTER, ODIE R. SEAGRAVES, BERNARD D. MARREN, IRVING STOLZ,

Defendants-Appellees.

Before:

LUMBARD, *Chief Judge,*
WATERMAN, MOORE, FRIENDLY, SMITH,
KAUFMAN, HAYS and ANDERSON,
Circuit Judges.

Appeal by the Securities and Exchange Commission from an order of the District Court for the Southern District of New York, Sylvester J. Ryan, *Judge,* 259 F. Supp. 99, denying its motion for a preliminary injunction with respect to alleged violations of § 13(a) of the Securities Exchange Act

and of Rules 13a-11 and 10b-5 thereunder. Reversed in part, vacated and remanded in part.

PHILIP A. LOOMIS, JR., General Counsel, Walter P. North, Associate General Counsel, Meyer Eisenberg, Assistant General Counsel, David J. Myerson, Attorney, *for Securities and Exchange Commission.*

PAUL, WEISS, RIFKIND, WHARTON & GARRISON, New York, N. Y., Simon H. Rifkind, Richard H. Paul and Thomas R. Farrell, of Counsel, *for Defendants-Appellees Great American Industries, Inc., Walter S. Mack, Bernard D. Marren and Irving D. Stolz.*

O. JOHN ROGGE, New York, N. Y., *for Defendant-Appellee Jerome Matusow.*

WALTER FELDESMAN, New York, N. Y., Justin W. D'Atri of Counsel, *for Defendant-Appellee Frederick J. Pagnani.*

LEINWAND, MARON & HENDLER, New York, N. Y., Milford D. Gerton of Counsel, *for Defendant-Appellee William Thomas Beard.*

FRIENDLY, *Circuit Judge*:

This appeal by the SEC from an order of the District Court for the Southern District of New York, 259 F. Supp. 99, denying its motion for a temporary injunction with respect to alleged violations of § 13(a) of the Securities Exchange Act and of Rules 13a-11 and 10b-5 thereunder was initially heard by a panel consisting of Judges Moore and Hays of this court and Chief Judge Zavatt of the District Court for the Eastern District of New York. Since certain

conclusions supporting the majority's decision to affirm ran counter to the position of the majority of the panel in *SEC* v. *Texas Gulf Sulphur Co.*, —— F. 2d —— (1968), which was under advisement at the same time, we determined that this case also should be heard *in banc* upon the briefs already submitted and the opinions prepared by the panel.

The disposition of the motion for a temporary injunction on the basis of affidavits and of testimony at "private conferences" before the SEC, although apparently acquiesced in by all parties, illustrates the defects in that practice, which we subsequently condemned in *SEC* v. *Frank*, 388 F. 2d 486, 490-92 (1968). The SEC's application was supported by a long affidavit of one of its lawyers and a short one from its Chief Mining Engineer; the former gave mere excerpts from various of the press releases and reports of which the SEC complained rather than the full text. Cf. *SEC* v. *Frank, supra*, 388 F. 2d at 489. Defendants answered with eight affidavits; some but by no means all of the relevant documents were annexed. No witnesses were heard but the SEC furnished the court with transcripts of the testimony it had taken. In his opinion Judge Ryan complained time and again that documents were not quoted in full text or presented as exhibits. As to certain issues the degree of knowledge possessed by corporate officers was critical, yet the judge had to determine this without seeing or hearing them, cf. 388 F. 2d at 491. The disorganized record has similarly handicapped us in considering this appeal. We reaffirm our ruling in *SEC* v. *Frank, supra*, and further place the Commission on notice that even when exceptional circumstances may warrant dispensing with an evidentiary hearing on a motion for a temporary injunc-

tion or the defendants may agree to that course, the district courts are not to accept the kind of moving affidavit that was offered here; the Commission has sufficient facilities to enable it to present documents in full text.

The action concerned a number of press releases, reports, and failure to report and disclose during the winter and spring of 1966, relating to three mining ventures of a company somewhat extravagantly called Great American Industries, Inc. (GAI)—a sulphur property in California, a copper mine in Arizona, and a sulphur mine in Nevada. Mining was a new activity for GAI which had previously been engaged through subsidiaries in the manufacture and sale of a variety of less glamorous products such as cookies, crackers, rubber goods and soft drinks. From January 1, 1965 to January 1, 1966, the price at which GAI common stock traded on the American Stock Exchange never exceeded $2 per share; the average number of shares traded daily during 1965 was 8,500. In contrast, from January 13, 1966, when GAI announced its first venture into mining until the Commission suspended trading on April 29, 1966, an average of 185,000 shares was traded daily. During this period the price of the stock went as high as 14⅝; on April 27 the closing price was 10⅛.

The Commission's complaint alleges three categories of violations. The first is that in press releases and in 8-K reports to the SEC and the American Stock Exchange, GAI made untrue statements of material facts or omitted to state material facts "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," in violation of Rule 10b-5 as to the press releases and §13(a) and Rule 13a-11 as to

the reports. See also §18(a). The second is that the corporation and its officers violated the same provisions by failing to disclose in press releases and 8-K reports that a substantial portion of the consideration for the three properties was known by them to be payable not to the owners but to intermediaries. The third is the opposite side of the latter coin; the SEC contends that in instances when the sellers failed to disclose the large participation of the finders to GAI, they violated Rule 10b-5. Before proceeding further we note that such of defendants' arguments as are based on a narrow construction of the phrase of §10(b) of the Securities Exchange Act and Rule 10b-5, "in connection with the purchase or sale of any security," have been rejected by our decision in *SEC* v. *Texas Gulf Sulphur Co., supra,* — F. 2d at —.

I.

The first press release of which the SEC complains was issued by Walter S. Mack, chairman of GAI, on March 21, 1966. Although a final paragraph dealt also with the California sulphur property, the SEC's criticism relates to a preceding one concerning the Arizona property which we reproduce in the margin.[1] Mack had acquired the option to

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[1] "Walter S. Mack, Chairman of Great American Industries, Inc. just announced today that they had completed arrangements to acquire an option for 60 days on a new mining strike of Copper, Silver, and Gold ore in the Tiger Mining District, Yavapai County, Arizona, consisting of 24 claims on about 480 acres. During this 60-day period, Great American Industries will have additional investigations made to help further appraise this property and its reserves.

"Mr. Mack stated that this new discovery is close to the area called 'Silver Mountain' in Arizona, which has had a history of good production of Silver and Gold. It is an open face pit lode mine, which will make it easier and economical to get into pro-

the Arizona mine on the advice of Arthur D. Little, Inc., a reputed engineering firm, and later of another engineer, Dr. Edward Van Dornick. The Little report, dated March 18, 1966, had characterized the property as "a potentially promising ore deposit" which should be explored "to accurately determine its potential value." The report estimated the cost of such an evaluation at $72,000 plus the $50,000 down payment required to obtain an option.

While injunctive relief would hardly be warranted if this issue stood alone, the release, perhaps unintentionally, created an exaggerated impression. We refer particularly to the sentence, "Mr. Mack stated that he is advised that the mine can be in production within 90 to 120 days and will ship its concentrated ore to one of the large existing smelters in Arizona, at not too great a distance." Although literally true, this scarcely conveyed what was the fact, namely, that GAI then had no intention of putting the mine in production unless the additional investigations during the 60-day period of the option showed that this would be warranted. The difference between what was said and what should have been is illustrated by a clarifying press release dated April 12, stimulated by the SEC's suspension of American Stock Exchange and over-the-counter trading in GAI stock on March 31. This attributed the SEC's action to reports and rumors emanating from others and made clear, "It is not now known whether or not there

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duction. Mr. Mack stated that he is advised that the mine can be in production within 90 to 120 days and will ship its concentrated ore to one of the large existing smelters in Arizona, at not too great a distance. This mine has the added advantage of having both water and power close by. Mr. Mack stated that at this time, he was unable to estimate the earning potential of this property."

is a commercially mineable ore body at the property." The release went on to say that GAI had exercised its option, which had 45 days still to run.[2]

Despite the April 12 release GAI filed with the SEC on April 13 an 8-K report prepared by defendant Marren with the aid of defendant Stolz. After reciting the acquisition of all the stock of Basin Mining Company, the owner of the Arizona property, the report continued:

> Investigation by Great American Industries, Inc., indicates that this mine can be operated within a period of 90 days on a basis which will produce an operating profit of approximately $50,000 a month. It is also anticipated that substantial ore reserves will be available for development on a larger basis which would involve the installation of equipment and an investment of more capital funds as a result of which the net profit may be increased to $3,000,000 a year.

Complaint by the Commission's staff resulted in a letter from the company's counsel on April 14 acknowledging that the statements concerning the Arizona property were inconsistent with the press release, claiming they were included "through inadvertence," and enclosing a substitute page which replaced the quoted passage by the following:

> Investigation by Great American Industries, Inc. indicates that this mine can be operated within a period of 90 days. It is not now known whether or not there is a commercially mineable ore body at the property. The Company has no reports establishing the existence

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[2] The release also said it was now "intended to construct and operate . . . a mill within four to five months, despite the fact that it is not now known whether or not there is a commercially mineable ore body at the property."

> of such an ore body. Only limited exploratory work has been done thus far, and further exploration is intended.

The difference between the two versions is too great for rescue on the basis, advanced by the district judge, of being "not an admission of guilt but rather the act of prudent business men to avoid unnecessary conflict and perhaps litigation with a Government department." 259 F. Supp. at 107-08. Experienced counsel for GAI took no such view; conceding that the statement in the initial filing was wrong, they sought to excuse it as inadvertent. In view of the prompt correction no harm seems to have been done—indeed GAI contends the report had not been placed in the public file either of the Commission or the ASE until the substitute page was filed. The Commission, however, cannot be expected to have the time, the resources or the material to enable it to police 8-K reports as quickly and thoroughly as it did here. The statute places the duty of filing correct reports on the issuer; while inadvertence and prompt correction after complaint are mitigating circumstances and may affect liability for damages, they do not defeat the SEC's right to injunctive relief. See *SEC* v. *Texas Gulf Sulphur Co., supra,* — F. 2d —, — (concurring opinion of Friendly, *J.*).

On April 15 the SEC lifted the suspension on trading. Twelve days later Mack issued another press release announcing the proposed acquisition of the Nevada claims, the third of the properties, and commenting on the other two. As to the Arizona property he stated that the "machinery and equipment was now being ordered which should put this property into production in about 90 days." As

to the California property the release said that "additional drilling and exploratory work is now being carried on by the mine owners on the 340 acres of sulphur-bearing deposits in California under option to Great American but results on this work will not be available for 60 days." Again the SEC complained and rectification was made by an amplifying press release the next day, April 28. As to the Arizona properties this was simply a reaffirmation of the statement in the April 12 release and the corrected 8-K report "that it is not now definitely known whether or not there is a commercially mineable ore body at the property." The deficiency as to the California property was much more serious. The April 28 release disclosed that the two engineering firms retained by GAI as to this property, Arthur D. Little, Inc. and Behre, Dolbear Co., had reported "that their investigation of the claims have not indicated sufficient promise of commercially mineable ore bodies to justify further expenditure by Great American on such investigations. Consequently, the Company has terminated the work by these engineering firms and will concentrate its efforts on the Nevada claims." In other words, the California venture had disappeared for the time being and would be revived only if further work by the sellers should induce GAI to take a new interest.[3]

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[3] Behre Dolbear & Co. had been engaged by Mack for the specific purpose of determining the quantity of sulphur bearing ore in the California property. On April 12, 1966, Dr. Behre met with Mack and informed him that the ore "was petering out below the surface" and expressed serious doubts as to the commercial value of the California property. On the following day, Mack met with the sellers and conveyed Behre's opinion. They criticized the core recovery techniques, asserting that pulverized sulphur

The final item under this heading is that GAI's 8-K report for April, 1966, included a "feasibility study" of the Nevada properties. This had been prepared by Canyon State Mining Corp., one of the sellers, but the report did not disclose this. Obviously this was an omission of a material fact; GAI in effect recognized this by including a reference to it in a subsequent 8-K report.

The evidence we have summarized compelled a finding that the deficiencies in the press releases and reports were not merely negligent, as alleged with respect to the April 12 press release in *SEC* v. *Texas Gulf Sulphur Co., supra,* but something more. The Commission was entitled to an injunction against their repetition.

II.

In this section of the opinion we state the facts as to the division of the consideration paid by GAI for the three properties, GAI's knowledge thereof, and the releases and reports with respect thereto:

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was being blown away with a resulting diminution in assay values. The parties agreed to alter the recovery technique.

Behre confirmed his pessimism in a letter dated April 14 but agreed to continue as agreed with the sellers. Behre subsequently reported by mail on April 20 that he had confirmed the validity of the core recovery techniques and reaffirmed his conclusion that the property contained no appreciable sulphur deposits. Mack met with Behre and his associates on April 26 and Mack informed the sellers the next day of the unsatisfactory results of Behre's testing. The latter repeated their criticism of the technique and declared that they would continue exploration at their own expense since Mack had indicated that GAI would expend no further sums on the property. Mack also stated that if and when the property had been proved worthwhile, a new contract of sale would be negotiated. Mack immediately informed the GAI board of this action and the April 27 press release followed thereafter.

(1) *The California property.*

In November 1965 defendant Matusow, whom Mack had known for a year and a half and believed to be a real estate broker, called Mack's attention to this property, owned by Consolidated Sulphur Corporation. Later Matusow introduced Mack to Kenneth Porter, president of Consolidated. They worked out a letter agreement wherein Consolidated granted GAI a 90 day option, pending reports by the two engineering firms GAI had retained. If GAI decided to make the purchase, it was to pay "to the owners of the property" 1,600,000 shares of its stock and $250,000 in cash. Porter testified before the SEC that he had agreed with Matusow that a "group" consisting of Matusow, defendant Lester and one Frank Howard were to receive 600,000 of these shares for their "services," although it does not appear that Mack ever saw Howard. The moving affidavit of the SEC attorney alleged that defendant Seagraves was to receive half of Lester's share; Lester denied this and Seagraves' affidavit says he was never to get anything except as a stockholder in Consolidated Sulphur.

GAI's 8-K report filed on February 15, 1966, recited the arrangement to issue 1,600,000 shares and said nothing about the destination of the 600,000. Judge Ryan found there was no direct evidence that GAI or any of its officers knew of the latter and evidently refused to infer such knowledge; this surely was not clearly erroneous.

(2) *The Arizona property.*

Mack first heard of this property from defendant Beard who owned it, apparently through ownership of all the shares of Basin Mining Company. Matusow soon ap-

peared on the scene. The option agreement of March 21, 1966, providing for a purchase price of $50,000 plus 200,000 shares of GAI stock, was with Beard. The later agreement of April 5, 1966, was with Beard as the "Stockholder" of Basin; he represented himself as owning all its stock and warranted that he would take and hold the GAI shares for investment and not with a view to sale or distribution. In fact, as acknowledged in Beard's affidavit, he had agreed early in the winter that if Matusow could obtain $50,000 to enable him to pay off a bank debt, he would give Matusow five-sixths of any stock received in addition. Matusow later informed Beard that he had retained defendant Pagnani to handle the legal work and that Pagnani was to receive one-sixth of any stock—this to come out of Matusow's share. The press release of April 12 and the 8-K reports of that month referred to the issuance of 200,000 GAI shares without mentioning that only one-sixth would go to Beard. The District Court found, however, 259 F. Supp. 107:

> "There is no evidence that the corporate-defendants knew about this private agreement, although they knew Matusow as a finder who was connected with Beard and had been rather active in the negotiation of this deal, and they knew Pagnani as Beard's attorney. They undoubtedly knew that Matusow and Pagnani were to be compensated by Beard."

We must accept these findings.

(3) *The Nevada property.*

This property was called to Mack's attention in April 1966 by Beard and Matusow. It was owned by Pacific

Sulphur Company, a consortium representing three interests, Crofoot Lumber Co., Commonwealth Silver Co., and Canyon State Mining Co. The contract dated April 22, which the SEC has not produced, evidently provided for the issuance of 300,000 GAI shares, then selling in the $11-$14 range. These were to be distributed 17,340 to Crofoot,[4] and 41,390 each to Canyon and Commonwealth, and 200,000 to Matusow, Pagnani and Beard, with the former to retain 5/6 or 134,000 shares and the latter 33,000 each. Matusow guaranteed Crofoot that its shares would be worth $250,000. Press releases of April 27 and 28, 1966, and an 8-K report filed on May 11 said only that GAI had purchased the Nevada claims for 300,000 shares of its common stock "which are to be taken by the sellers for investment and not for public distribution."[5] In this instance GAI and its officers did have knowledge of the peculiar division of the consideration.

The contract could not be closed as scheduled because of the suspension of trading in GAI on April 29 and a suit brought by a person claiming to have had a purchase contract with Crofoot. Later it renegotiated so that Matusow, Beard and Pagnani would each receive 15,000 shares, Crofoot's portion was raised to 44,232 shares and Canyon's and Commonwealth's to 105,384 each, GAI assumed Matusow's guarantee to Crofoot, and other changes favorable to GAI were made.

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[4] Apparently Crofoot was also to receive certain royalty payments.

[5] We are told that the 8-K report, not proferred by the SEC as an exhibit, "merely listed the seller of the property as Pacific Sulphur Corporation."

III.

On this appeal the Commission's contention that failure by GAI and its officers to disclose the large portions of the consideration going to persons who were not owners must thus be limited to the Nevada property, as to which alone they were found to have had knowledge.[6] As to this, the April 27 and 28 press releases and the 8-K report for that month at least omitted to state a material fact which the company had a duty to disclose; indeed the reference to the issuance of the 300,000 shares to "the sellers," with only Pacific Sulphur so identified, could well be said to be an "untrue statement of a material fact."

This court has defined a material fact as a fact to which "a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." *SEC* v. *R. A. Holman & Co.*, 366 F. 2d 456, 459 (2 Cir. 1966), quoting *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2 Cir.), cert. denied sub nom. *List* v. *Lerner*, 382 U.S. 811 (1965). We have further developed our views on materiality in *SEC* v. *Texas Gulf Surphur Co., supra,* F. 2d at . That reasonable traders in stock of a company buying mining property would be influenced by knowledge that the vendors were willing to pay two-thirds of the price to persons who could produce a buyer would not appear to require extended argument. A person learn-

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[6] In addition to the passages previously quoted, Judge Ryan stated, 259 F. Supp. at 109:

> We find specifically that the Commission has failed to establish on this motion that defendants knew the arrangements which existed between the seller and the finders on the California and Arizona properties.

ing that GAI had issued 300,000 shares of its stock, worth some $3,600,000 at then market prices, for the Nevada properties, might well have a different idea of the properties' value if he knew the owners were in fact receiving only $1,200,000, with the difference going to intermediaries who had effected the sale. Such knowledge would not cease to have been material even if the mine later turned out to have been a bargain. This is not to say that any variation of a finder's fee from conventional norms would be so material as to require disclosure; willingness to pay intermediaries two-thirds of the price (the fraction being here subject to some slight reduction for Matusow's guarantee of the value of the Crofoot stock) is so unusual as to raise legitimate question in the mind of a prospective purchaser of GAI stock whether GAI had not been "taken" and whether the Nevada mine was worth anything like what GAI was paying for it. Even if we were to assume that GAI and its officers did not realize the materiality of the distribution of the 300,000 shares, our holding in *SEC* v. *Texas Gulf Sulphur Co., supra,* with respect to TGS's April 12 press release in that case settles that Rule 10b-5(2) authorizes the granting of injunctive relief. While the trial judge might still have been within the bounds of allowable discretion in holding that no sufficient case for issuing an injunction had been made if this episode stood alone, see concurring opinion of Friendly, *J.*, in *SEC* v. *Texas Gulf Sulphur, supra,* F. 2d , , the failure to disclose the known destination of 200,000 of the 300,000 shares must be considered along with the misleading releases and reports considered in section I of this opinion. As in *SEC* v. *Texas Gulf Sulphur Co., supra,*

our decision is limited to injunctive relief; we intimate nothing as to liability for damages.

IV.

The SEC seems to regard the case against the defendants who failed to disclose to GAI the large payments to be made to "finders" as identical with that against GAI and its officers for failure to reveal what the company knew. The argument runs as follows: First, the large proportion of the consideration to go to the finders was "a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."—a position with which we have expressed sympathy in section III. Second, Rule 10b-5 condemns an omission to state such a fact by "any person," by the use of certain specified means of communication presumably present here, "in connection with the purchase or sale of any security." Finally, the omission was "in connection with" these defendants' proposed purchases of stock from GAI.

It must be conceded that imposing on sellers of property or finders a duty of full disclosure to a buyer issuing securities in exchange, with a consequent duty on the part of the latter to publicize material facts so disclosed, would increase the protection afforded investors and traders by the securities laws. On the other hand, to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast to "insiders" or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful

consideration. Without attempting to predict the result of such consideration, distinctions might be drawn, for example, according to the importance of the transaction, between sellers of property and finders, or between finders acting solely for such sellers and those having a special relationship with the issuer. We are loath to undertake this task where, as noted at the outset, the record is so unsatisfactory. We find there is no need for doing so.

With respect to the Arizona property there was evidence concerning defendants Beard, Matusow and Pagnani that went considerably beyond non-disclosure. The purchase agreement recited that the stock of Basin Mining Company was owned by Beard "and others, less than ten (10) in number, who have beneficial interests therein." Marren, vice president of GAI, stated in discussing the closing of the Arizona transaction, "When I asked specifically who were the other individuals with a benefit interest in Basin Mining Company, Mr. Beard [the seller] said that they were local associates of his. I noted that paragraph 11 of the purchase contract stated that 'the parties agree that no broker or finder has brought about the transaction contemplated by this agreement.' " Matusow and Pagnani were present when these statements were made. Beard's affidavit did not deny the statement attributed to him. Matusow's asserted he told Marren ' that the others were Pagnani and me"; Pagnani's claimed that his function was solely to render legal services and, inferentially, that GAI knew this. Even if we accept Matusow's version, it was so far from the full truth, namely, that Matusow and Pagnani were to receive five-sixths of the consideration—four-sixths of this going to Matusow for "finding"—as to run foul of

the principle that "One party to a business transaction is under a duty to disclose to the other before the transaction is consummated . . . such additional matters known to him as he knows to be necessary to prevent his partial statement of the facts from being misleading. . . ." Restatement of Torts 24.551(2)(b) (Tent. Draft No. 12, April 27, 1966). Whatever the situation might otherwise have been, Marren's question required those present at the closing to speak up and clarify what was meant in the purchase agreement by "finders" and "local associates," and to explain their financial relationship. This duty was not discharged. Since the conduct of Beard, Matusow and Pagnani constituted common law fraud "in connection with" the purchase of securities, Rule 10b-5 is plainly applicable, see *SEC* v. *Capital Gains Research Bureau,* 375 U. S. 180, 195 (1963); 3 Loss, Securities Regulation 1435 (1961 ed.), and the SEC was entitled to an injunction against them irrespective of Matusow's later involvement in the California property.

This leaves only the propriety of the denial of a temporary injunction with respect to Lester and Seagraves, who were concerned with the California mine alone. Here the record is quite confusing. While Lester admitted that he knew 37½% of the GAI shares were to be allotted to Matusow and that he and Howard were each to receive one-third of the allotment, he claimed that his share was to be paid for relinquishing an oral agreement to buy the property. As noted above, Lester denied that Seagraves was to have any part of his share and Seagraves asserted that he was never to get anything save as a stockholder of Consolidated Sulphur.

On this state of the record the judge was surely justified in denying a temporary injunction with respect to Seagraves. And, even on the SEC's view of the law, it is arguable that Lester reasonably supposed Matusow had revealed the facts to GAI. It would be most unwise for us to move into new legal ground from such a soggy factual base. Rather we shall vacate the denial of a temporary injunction against Lester and Seagraves and remand the issue to the district court which, if the SEC should choose to pursue this dispute, relating to events of two and a half years ago, can consolidate the applicatiton for a temporary injunction against these two defendants with a final hearing. See F. R. Civ. P. 65(a)(2).

We therefore reverse so much of the judgment as declined to issue a temporary injunction against defendants GAI, Mack, Marren, Stolz, Beard, Matusow and Pagnani and direct the issuance of an appropriate injunction. We vacate so much of the judgment as declined to issue a temporary injunction against defendants Lester and Seagraves and remand for further proceedings consistent with this opinion.

WATERMAN, *Circuit Judge* (concurring):

I concur in Judge Friendly's opinion. The area of the law into which the Securities and Exchange Commission has now moved is an area in which perceptive regulatory proceedings have been long overdue when it is recognized that the intent of Congress was to protect individual outside investors who buy and sell corporate securities on national exchanges from receiving incomplete or inaccurate information from corporate officers and corporate manage-

ment. In adjudicating the Commission's regulatory efforts in the area, we must, of course, move on a case-by-case basis, and with care, as in *SEC* v. *Texas Gulf Sulphur* (2 Cir. Aug. 13, 1968) but with the Congressional mandate to protect investors always in mind. As stated in the concurring opinions of my brothers Kaufman and Hays, there is a world of difference on the one hand between cash buy-sell agreements and agreements to compensate finders in cash and, on the other, those agreements when management arranges to have blocks of stock be the consideration. For now, in view of the somewhat casual and confused record before us here, I am content with Judge Friendly's conservative disposition of the issues presented to us in the present case.

KAUFMAN, *Circuit Judge* (concurring):

My dissenting brother, Judge Moore, leaves the impression that the majority is dealing with startling new principles, ignoring that what we say today follows in the wake of *SEC* v. *Texas Gulf Sulphur Corp.*, Docket No. 30882 (2d Cir. decided Aug. 13, 1968). I therefore have no difficulty in concurring in the majority opinion. And since the record is quite obfuscated as to the defendants Lester and Seagraves, I agree that we are compelled to remand their cases for further hearings.

Inasmuch as these cases are of great importance to the financial and business community, I believe it appropriate to add this caveat: Those who buy or sell securities may no longer assume that the unmended fences of common law fraud will remain the outer limits of liability under Rule 10b-5. Prof. Bromberg has succinctly stated that the rule's proscription is considered to be "closer to unfairness than

what either lawyers or laymen usually think of as fraud." A. Bromberg, Securities Law: Fraud: SEC Rule 10b-5, ¶ 1.1 at 5 (1968).

Thus, in the Arizona affair—and perhaps in the California transaction as well—the finder defendants received exorbitant fees for the performance of minimal services. They were awarded such a disproportionate percentage of the total consideration paid for the property that, were this arrangement disclosed, it would clearly have indicated the property could not be worth the price paid. This is not, as Judge Moore hypothesizes, similar to a marital transfer where there could be other plausible explanations for the proposed allocation. Matusow and Pagnani performed the services that finders usually perform and, on the abbreviated record before us, it is idle speculation to attribute their actions to an alleged joint venture especially in the light of their deliberate misrepresentations to G. A. I. of how the proceeds would be allocated. Here, had G. A. I. known of the proposed allocation of the proceeds, it might well have refused to proceed with the negotiations. Accordingly, in not revealing the percentage of the purchase price that was destined for the finders, the defendants failed to disclose a material fact.

While it is true that in the usual business transaction a seller need not disclose how he intends to dispose of the money paid him, this was not an ordinary transaction. The excessive harvest being reaped by those who had sown but little was so extraordinary that I question the propriety of the failure of the finder defendants to disclose it.

My basic text is that the property was not sold for cash but for securities. The limits of "fraud" under the securi-

ties law are not identical with those of common law deceit —an appropriate standard were this a cash transaction.

In a cash transaction, only the buyer and the seller are affected by a "fraud." If the buyer does not get the best price, only he, and no one else, is harmed. Where the buyer pays with securities, however, it is not too difficult to discern that many others will perforce be affected because the issuance of the new securities is likely to influence the market for the outstanding stock of the company. (Throughout the relevant period, it should be noted, G. A. I.'s stock was traded very actively—on the occasions when the SEC permitted it to be traded.) Thus, the injury is not exclusively to those who are parties to or participate in the negotiations, but to passive shareholders, potential purchasers, and an ever-increasing circle of others. It seems clear to me that this potential for spreading damage caused by the failure of the finders to disclose a material fact would warrant injunctive relief. I hasten to add, however, that it should not be inferred from what I have said that I am expressing any view on the propriety of a private action for damages.

I am reluctant to see the limitations of the tort of deceit stenciled onto the securities laws lest the resulting maze lead us into the common law morass of overfine distinctions which would frustrate the securities statutes. As an illustration, the common law would distinguish between partial disclosure and nondisclosure. Common law cases have held, for example, that the owner of a dwelling, although he knows full well that his home is riddled with termites, can unload it with impunity upon a buyer (without disclosure), and go on his happy way. E.g. *Swinton* v. *Whitinsville Sav.*

Bank, 311 Mass. 677, 42 N. E. 2d 808 (1942). See Prosser, Torts, 711 (3d ed. 1964) (calling such cases "singularly unappetizing"). The Securities and Exchange Commission, seeking to enjoin manipulation of such "intricate merchandise" as securities, H. R. Rep. No. 85, 73rd Cong., 1st Sess. (1933) 8, should not be fettered by such a wholehearted embrace of the doctrine of caveat emptor.

In sum, any claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed.

HAYS, *Circuit Judge* (concurring in the result):

Since the injunction to be issued against the defendants will presumably be cast in general terms, restraining further violations of the Securities Exchange Act, I concur in the result. However I would formulate a somewhat broader basis for liability than that upon which the majority opinion relies.

The corporate officers who participated in the purchases of the mining properties were aware, or should have been aware, that finders' fees were to be paid. They were under an obligation to inquire of the sellers of the property as to what part of the stock issued to them would be paid out as finders' fees and to report this information to the GAI board of directors and include it in press releases and reports. A rule that makes it the duty of corporate officials to report such material information only if they happen fortuitously to receive it does not go far enough in the protection of the corporation against fraudulent practices.

The finders who were to share in the excessive finders' fees were also under a duty to inform the purchasers of

the property of the amount of the fees. They knew or ought to have known that fees in the amount fixed would be a material fact to be considered by GAI in determining the price to be paid for the properties. Not only should they have been aware that knowledge of the amount of the fees would be material to traders in the stock of the corporation, but they themselves profited by any inflated value which the stock may have had by reason of their failure to disclose this material information.

Transactions in securities differ from ordinary buyer-seller deals. Other owners or potential owners of the same securities are directly affected by each transaction and the effects spread to other securities.

Moreover, although the role of the finders in the sales to GAI probably cannot correctly be classified as fiduciary in the traditional sense, neither were the finders engaging in what may be strictly characterized as an arm's length transaction. They were something more than mere agents of the sellers since their function was to bring the parties together. They owed some duty to the buyers at least to warn them of the unusual nature of the transactions in which they were engaging.

I leave to a more appropriate occasion consideration of the duty of the sellers themselves in a situation involving the issuance of securities in return for property.

MOORE, *Circuit Judge* (dissenting):

Were the majority opinion to come before the SEC for review, the SEC could justifiably find that its factual state-

ments and, particularly, its omissions of material facts bring it well within the proscriptions of SEC rules and regulations. Rules 10b-5; 13a-11; §§10b-5, 13(a); 16(a). Therefore, since so little of the case presented to the district court (Judge Ryan), and which formed the basis for his decision, has been selected by the majority in support of the conclusions it chooses to reach, a much fuller disclosure of the facts actually before Judge Ryan must be made. Such a review is only fair to Judge Ryan in appraising his decision, particularly since the majority disagree with his resolution of the facts. The record was submitted to this court in a joint appendix approved by the parties and so directed by this court (January 23, 1967). It contains all the letters, documents, agreements, press releases and undisputed facts necessary for the immediate decision, namely, whether there was sufficient proof of reasonable likelihood of success and clear and present danger as to call for the drastic remedy of a preliminary injunction.

The case came before Judge Ryan solely upon the SEC's motion for a preliminary injunction to enjoin alleged violations of Sections 10(b), 13(a), 16(a) and Rules thereunder. Thus, the facts submitted, the matters developed on the oral arguments and the law pertaining to preliminary injunctions formed the basis for his decision. This is apparent from the order in which he denied the motion after having "considered the pleadings, motion for preliminary injunction, transcripts, exhibits, memoranda and affidavits filed in support of said motions and in opposition thereto."

THE "COMPLAINT FOR INJUNCTION"

The complaint describes the defendants Walter S. Mack (Mack) as Chairman of the Board of Directors and a "controlling person" of Great American Industries, Inc. (GAI) and as having a beneficial ownership of 316,366 shares out of 5,200,000 shares outstanding of GAI stock. The defendants Marren, Stolz and Mele are alleged to be directors of GAI; Marren, Financial Vice-President and a member of GAI's Executive Committee; and Stolz, General Counsel for GAI and an Executive Committee member. The other defendants, Matusow, Pagnani, Beard, Lester and Seagraves are not alleged to be officers or employees of GAI.

The gravamen of "COUNT ONE" is that "Mack, Marren and Stolz as part of a scheme to defraud GAI and its shareholders (1) caused GAI to sell and divert substantial amounts of GAI's authorized but unissued common stock to certain of the defendants for little or nominal consideration, and (2) caused the preparation, public filing and dissemination of false and misleading information concerning" the consideration paid or to be paid for certain mining properties, the parties to these acquisitions, and the status and potential of such properties, thereby concealing the purpose and effect of such transactions from GAI and from the stockholders. The complaint alleges that as a result GAI stock listed on the American Stock Exchange has "since January 1966 increased from a low of 2⅜ to a high of 14⅝ per share."

COUNTS TWO, THREE and FOUR deal with allegedly false 8-K reports (Sec. 13(a) of the Securities Exchange Act of 1934 (the Act) and Rule 13a-11 thereunder) and COUNTS

FIVE and SIX relate to alleged failures to file changes in beneficial ownership statements by Mele and Stolz (Sec. 16(a) of the Act and Rule 16a-1 thereunder). No appeal is taken as to COUNTS FIVE and SIX.

The Relief Sought

The complaint in substance demands a preliminary and permanent injunction against any violations of the Act.

THE MOTION FOR A PRELIMINARY INJUNCTION

Supporting the motion for a preliminary injunction were an affidavit of a Commission investigator which elaborated on the allegations of the complaint, an affidavit of the Commission's Chief Mining Engineer, and depositions before the Commission of Beard, Mack, Lester and Marren. In opposition were an affidavit of Mack, stating the business purpose of GAI in seeking the acquisitions, to which were attached twenty-five exhibits (A-Y). These exhibits included financial statements of GAI, letters and letter agreements relating to the acquisitions, press releases, 8-K reports, letters of Behre Dolbear & Company, and Arthur D. Little, Inc., expert mining consultants, which will be referred in greater detail in discussing the properties to which they relate.

The History of GAI

The immediate background of GAI may be traced from National Power & Light (1951), which became National Phoenix Industries. In 1957 National Phoenix acquired GAI and, as a result of a merger, GAI became the surviving corporation.

Mack became its president in 1958 and served in such capacity to date except during 1964-66. He had had a successful and distinguished business career, and is a well-known figure in the corporate and financial field. Since 1934 he had been the chief executive or financial officer of corporations in diverse activities, such as Phoenix Securities (financial), National Brass & Copper, Autocar, South Coast, Celotex and Certain-teed Products (building materials), Allied Stores (department stores), Pepsi-Cola (soft drinks), and Nedicks, Inc. (luncheonettes).

The Entry of GAI into the Mining Field

As the result of substantial losses sustained by a GAI subsidiary in years prior to 1966, GAI found itself with a tax loss carry-forward of some $6,000,000 which could be used as an offset against future profits. In looking for possible business acquisitions, Mack was primarily interested in enterprises which did not involve substantial labor costs and which had claims to natural resources and "would grow with the development of the United States and the world generally" (Aff. Mack). The fact that GAI had venture capital to invest brought many properties to Mack's attention amongst which were the three mining properties here in issue. These acquisitions or contemplated acquisitions are set forth as the transactions, in which the complained-of practices occurred, more specifically referred to as the Consolidated or California, Arizona and Nevada properties.

The Consolidated (California) Property

In November 1965 Mack learned of a California sulphur property owned by Consolidated Sulphur Corporation. In December 1965 an option to purchase the property for (1) $300,000 in cash, (2) 1,800,000 shares of GAI stock, and (3) a royalty of $3.50 per ton was discussed by Mack with Porter, Consolidated's president, but the terms were unacceptable to Mack. After making inquiries from prominent persons in industrial and banking fields as to the best mining experts, Mack engaged both Arthur D. Little Inc. and Behre Dolbear & Company to explore the property. Subject to receipt of their reports and approval by the GAI Board, a tentative agreement (January 11, 1966) was entered into between Consolidated and GAI, under which GAI received an option to purchase the property for 1,600,000 shares of GAI stock, acquired for investment and not for distribution, and $250,000 in cash. A detailed report of the proposed transaction was made to the GAI Board with the recommendation of approval of investigation expenses with future action to await the engineering reports. The public was advised by press release dated January 13, 1966, of the Board's approval of the acquisition "subject to verification of previous engineering reports and evaluation of said sulphur property." The employment of the mining experts was disclosed as was GAI's right not to consummate the purchase if the evaluation was not satisfactory.

This information was also set forth in some detail in GAI's January 1966 8-K report to the Commission.

The press release of January 13, 1966 was accurate in every detail. Equally accurate and even more detailed

was the information contained in GAI's 8-K Report for January 1966 (Item 2a), to which were appended all documents relating to the transaction, i.e., letter agreements, January 13, 1966, between GAI and Consolidated, letters of January 13, 1966, relating to approval by GAI directors, and letters of January 17, 1966, confirming employment of the mining experts, Arthur D. Little, Inc., and Behre Dolbear & Company, Inc.

The majority opinion omits to state these material facts and, insofar as it infers that the announcement of January 13, 1966 was to inflate the market price of GAI stock improperly (the opinion notes the increase in volume and in price from January 13, 1966 to April 29, 1966 of 2 low to 14⅝ high), it is "misleading"—"misleading" because the first press release of which the SEC complains was not issued until March 21, 1966.

A much fairer statement, requiring no inferences, would have been to point out that between January 13, 1966, and March 19, 1966, the price of GAI stock had risen gradually to 7⅞, without any possible stimulus from the March 21, 1966, publication.

Amongst other material facts omitted by the majority is the action (or, better, non-action) of the defendants, officers and directors of GAI, with respect to the stock during the rise. Mack, the chief executive officer, had very large stockholdings (the complaint alleges over 316,000 shares). During the rise from 1¾ to a high of 14⅝, he neither bought nor sold any stock. The defendant Stolz held in his own name and through an interest in a partnership over 15,000 shares; the defendant Marren 25,000 shares. No purchases or sales were made by either defend-

ant during the period here in issue except a sale of some 4,250 shares by Stolz' daughter and son-in-law, which stock they had received as a gift at an earlier date. Thus, it cannot be said that any defendant derived any personal advantage from the market rise. No motive, or even suspicion of a motive for personal gain, can be found in the proof.

Continuing on as to the Consolidated property, because of the necessity for further evaluation, the option was extended for five to six weeks from April 13, 1966, GAI to add $10,000 to the drilling program.

The March 21, 1966 release advised that "the sulphur-bearing property that the company was having investigated by Behre Dolbear and Company of New York City and Arthur D. Little, Inc., of Cambridge, Massachusetts, in California, was still being drilled and cored at the present time and that they would not be able to properly appraise this development until the final reports were submitted by these two companies which should disclose not only an estimate of the sulphur ore available, but indicate some estimate of the sulphur ore reserves, as well as include a recommendation of the proper method to be used for refining—and a feasibility report indicating estimates of costs and profit margins per tone of ore. It is expected and hoped that these reports will be finished and available within the next 30 days, at which time a final announcement will be made by the company concerning its plans in regard to this sulphur property."

The release of April 12, 1966, stated as to the Consolidated property: "It is not now known whether or not there is a commercially mineable ore body on these claims.

The sulphur claims are now being investigated for the Company by engineering firms of the highest reputation—Behre Dolbear & Company of New York City and Arthur D. Little, Inc. of Cambridge, Massachusetts. The Company, which has not as yet received any reports regarding the value and potential of these claims, is awaiting the results of their investigation. In due course, an announcement of Management's decision regarding exercise of the option on the sulphur properties will be made and will be based on the facts when known."

Thereafter, "in order to get a more thorough evaluation and appraisal of the various ore bodies," GAI agreed with Consolidated (April 13, 1966) to add $10,000 to the drilling program. The next day Behre Dolbear & Company wrote GAI that although "the tonnage possibilities do not favor hope for economically workable deposits," in order to satisfy the desire of GAI and Consolidated "to make certain that nothing is missed," they would "continue to explore the property by drilling and bulldozing."

Upon advice of the mining experts, GAI, unwilling to make further expenditures, agreed to permit Consolidated to continue drilling for the next two months.

The press release of April 27, 1966 announced that "additional drilling and exploratory work is now being carried on by the Mine owners on the 340 acres of sulphur-bearing deposits in California under option to Great American, but results on this work will not be available for about 60 days."

On April 28, 1966 a more detailed statement was made that "With regard to the California sulphur claims on

which Great American acquired the purchase option in January, 1966, the engineering firms of Behre Dolbear & Co., and Arthur D. Little Inc., have reported to the Company that their investigations of the claims have not indicated sufficient promise of commercially mineable ore bodies to justify further expenditure by Great American on such investigations. Consequently, the Company has terminated the work by these engineering firms and will concentrate its efforts on the Nevada claims. As previously announced, the owners of the California properties will continue exploratory work at their own expense and extended Great American's option purchase for an additional 60 days. The Great American management will consider any additional findings which the mine owners may develop and submit to it."

The finale of the Consolidated option resulted from a disagreement between GAI and Consolidated and the peremptory demand that GAI exercise the option by May 25, 1966. GAI did not do so.

Thus, as to Consolidated property, the record supports the accuracy of the releases of January 13th, April 12th, April 27th, and April 28th as well as the 8-K information. After reviewing the facts (almost all of which were documented) at length, Judge Ryan concluded "On these undisputed facts, it is difficult to find support for the Commission's charge that on the California transaction, the defendants were guilty of misleading and false statements in the 8-K forms or in their press releases." More affirmatively, the Court found the 8-K report and the press release to be "true and accurate." Certainly there is no basis for the reversal of this solidly supported finding.

The Arizona Property

Mack heard of an Arizona copper property in February or early March 1966 from its owner, defendant Tom Beard, who submitted two reports thereon, dated September 1965 and January 1966. Arthur D. Little, Inc. was employed by GAI to evaluate the property and submitted its report, dated March 18, 1966. Significant are two comments: "Our study has resulted in the conclusion that the property is fairly and honestly reported in Mr. Beard's reports dated September 17, 1965, and January 1966." and "We believe that there is sufficient evidence to indicate a potentially promising ore deposit." The report recommended that GAI proceed with a further evaluation" in specified steps and that Beard's request for a $50,000 down payment was justified. Little's judgment of Beard was: "We are impressed with the knowledge and sincerity of Mr. Beard and feel that an association with him would be advantageous from your point of view if you are interested in mineral industry investments."

On March 21, 1966, by letter agreement, GAI obtained from the owner Beard (Basin Mining Company) a 60-day option to purchase the property (480 acres) from him for $50,000 and 200,000 shares of GAI stock "to be issued to you [Beard]." Contrary to the Commission's position that the stock was to be obtained "by these defendants," no recipient other than Beard (Basin) is mentioned in the contract, and no stock was to be issued to anyone else. $50,000 were to be paid to Beard upon the signing of the option and $75,000 worth of mining machinery was to be transferred to GAI's account.

Beard was the sole owner of Basin Mining stock. He had entered into a joint venture agreement with Pagnani and Matusow which provided for their sharing in mining properties owned by Beard on a basis of 4/6 to Matusow and 1/6 each to Pagnani and Beard. The Court, however, found that "There is no evidence that the corporate defendants knew about this private agreement, * * *" and that "there was nothing false or misleading about the 8-K report or the press release to this effect [i.e., that Beard was the owner and the price was 200,000 shares]. As for other charges of falsity, the Court noted that the Commission was criticizing "Mack's business judgment in following the four reports of his experts," the criticism being based on an affidavit by the Commission's Chief Mining Engineer who did not share the opinion of the others. The Court concluded that this "does not mean that the corporate defendants were guilty of false or misleading statements in adopting the views of their experts."

In the press release issued on the same day (March 21, 1966), Mack announced the acquisition of the option, that further investigations would have to be made to appraise the property and its reserves, that he was advised that the mine could be in production within 90 to 120 days but that at that time "he was unable to estimate the earning potential of this property." The advice to Mack was confirmed in writing by Beard (April 5th) to the effect that the installation would take 90 to 120 days to complete and that concentrate shipments to the Inspiration Smelter and Refining Company should begin within 30 days.

Under date of March 28, 1966 Mack received an additional report from a chemical engineer whom he had re-

tained which, in substance, stated that surface exposures acceptable for "indicated and inferred calculations" were "more than adequate to justify an extensive investigation of the property" and that "Based on the indications [the property] could represent an extremely extensive ore body."

On March 31, 1966, Mack submitted this report to the Executive Committee of the GAI Board (the Board had previously reviewed the Beard and Little reports) and recommended exercising the option and making a supervisory management contract with Beard, who was to purchase machinery to put the mine into operation within 90 to 120 days "in a small way and continue to develop it and prove it up until the Board of Directors may at some future time feel it is safe to arrange the larger financing for operating it on a much larger scale," Mack saying, "This eliminates any serious risk to Great American Industries by this procedure."

On April 12, 1966 Mack by press release publicly reported these developments, including a Commission order of March 31, 1966 suspending trading of GAI stock, and stated in part, "It is not known whether or not there is a commercially mineable ore body at the property." He referred to limited exploratory work and an intention to explore further, including the construction of a small mill within four or five months "despite the fact that it is not now known whether or not there is a commercially mineable ore body at the property," Mack also stated with respect to rumors of rich strikes that "The Company has not been responsible for these rumors—and the Company disavows them."

Mack's statement in the April 27th release that "machinery and equipment was now being ordered which should put this property into production in about 90 days," and its qualification the next day (April 28th release) that the 90 days' expectation was not to alter the April 12th statement as to the uncertainty of commercially mineable ore were based upon reasonable expectations supported by proof upon which the Court was entitled to rely.

The Commission selects this statement in the April 27th release and labels it "false" but the record reveals that when this statement was made, Mack had the written commitment of Beard (April 5th) to this effect.

The Nevada Property

On April 18, 1966, Mack heard of a Nevada sulphur property. He and Behre of Behre Dolbear & Company, mining and geological consultants, visited the property. Under date of April 25, 1966,[1] Behre presented to Mack his written appraisal based upon a preliminary examination, in which he subscribed to the opinion that by adequate exploratory drilling, double the quantity of sulphur ore claimed could be obtained. This property was apparently owned by three companies—Crofoot Lumber Co., Commonwealth Silver Co., and Canyon State Mining Co., which formed Pacific Sulphur Company for the sale to GAI. The original price was to have been 300,000 shares of GAI stock and a royalty payment of $4,500,000 to Crofoot. On April 22, 1966, GAI agreed to purchase the property from Pacific Sulphur for 300,000 shares of GAI

[1] Mack's affidavit states the report to have been given on April 22nd.

stock. Under the agreement, Canyon State was to receive 41,330 shares, Commonwealth 41,330 shares, Crofoot 17,340 shares, Matusow who guaranteed $250,000 in cash to Crofoot 134,000 shares, 33,000 shares to Pagnani, and 33,000 shares to Beard.

The purchase price to GAI of this property was 300,000 GAI shares for the selling group. The majority characterize the division of the stock amongst the sellers as a "peculiar division of the consideration" but query, is a federal court years after the event to dictate what the sellers chose to do with the proceeds of their sale?

On April 27, 1966, Mack announced the acquisition for 300,000 shares. A lawsuit against the sellers to enjoin the sale caused a change in the contract which, as altered, called for a radical change in their *inter sese* arrangements as to stock allocation, an assumption by GAI of the Crofoot guarantee, and an undertaking by Canyon and Commonwealth to join with GAI in a sharing of further exploration costs.

These are the facts underlying the negotiations with respect to each of the three properties. They are supported by letters and other documents. The various press releases accurately reflect these facts. In summary, Judge Ryan was solidly buttressed by "undisputed facts" when he held (1) as to Consolidated that "it is difficult to find support for the Commission's charge that on the California transaction the defendants were guilty of misleading or false statements in the 8-K forms or in their press releases."; (2) as to Arizona that "There was nothing false in the press release of April 27, 1966, reporting the ordering of machinery and equipment in order to put the property into production.

This was entirely true, for Mack had entered into such an agreement with Beard on April 5, 1966."; and (3) as to Nevada that there was no "failure to disclose the true purchase price demanded by the sellers."

In the face of these undisputed facts, how does the majority reach its result? Abstaining from dealing with the documented facts, they prefer to characterize the papers before Judge Ryan as a "disorganized record," and believe that some knowledge (they do not say what) possessed by the corporate officers was "critical" and that despite the letters and documents, the officers should have been seen and heard. Why or for what purpose, since these facts were undisputed, they do not disclose.

The majority satisfy themselves with their own finding (thereby saying, in effect, that there was no sufficient evidence to support Judge Ryan's contrary finding) that "the deficiencies in the press releases and reports were not merely negligent, * * * but something more." What "more" they do not choose to reveal. However, what little they do reveal will not withstand factual analysis.

They say that the release (March 21, 1966) relating to Arizona "created an exaggerated impression" because Mack stated that "he is advised" [as he was in fact] that the mine could be put in operation within 90 to 120 days. Forced to admit this was "literally true," they indulge in the unsupported (indeed false) assumption that "GAI then had no intention of putting the mine into production unless the additional investigations during the 60-day period of the option showed that this would be warranted." The fact that another release some three weeks later (April 12th) also accurately stated the then status of the exploratory

work does not make the March 21st report either misleading, false or deficient.

No proof was produced by the SEC that the anticipation mentioned in the April 12th release was not based on reasonable premises. That the SEC may have preferred to allay any optimism or hopeful anticipation (in contrast with their criticism of "gloom" in *Texas Gulf Sulphur*) does not make GAI's acquiescence an admission of guilt. As Judge Ryan quite properly said:

> "The fact that the corporate-defendants modified the wording of the 8-K Form on the day following at the urging of the Commission is not an admission of guilt but rather the act of prudent businessmen to avoid unnecessary conflict and perhaps litigation with a Government agency charged with regulating their activities."

Allocation by the Sellers, Consolidated (California), Beard (Arizona) and the Nevada Group of the GAI stock received or to be received for their Properties.

Unable to find the necessary proof to refute Judge Ryan's findings, the majority tread upon "new ground" "to impose on sellers of property * * * a duty of full disclosure to a buyer issuing securities in exchange" and place upon the buyer the duty "to publicize the material facts so disclosed." Here is indeed an astounding proposition of law.

Out of all the SEC charges relating to the sellers' distribution of the proceeds, the majority concede that they "must be limited to the Nevada property." Even as to Nevada, the majority confuse the question of value and the fairness of the purchase price with the question of distribution of the purchase price. This conclusion is evident

from the majority's unfounded assumption that GAI might have been "taken" and the mine might not have been "worth anything like what GAI was paying for it." But the SEC does not challenge worth. This confusion is made more evident by the majority's hypotheses that 300,000 shares of GAI stock were worth $3,000,000 and that the owners "were in fact receiving only $1,200,000." The fact that others were designated to receive $2,400,000 is unrelated to the value of the property acquired. No proof was submitted to Judge Ryan, and no claim is made by the SEC that the property did not have this value.

Despite the majority's concession, the situations in Consolidated and Arizona point to the extremes to which the SEC presses its pointless point.

Consolidated (California)

Although this transaction was not consummated, the SEC charges that of the 1,600,000 GAI shares to be paid "the defendants Matusow, Lester and Seagraves would have received 600,000 of the 1,600,000 shares even though they contributed no property or services of any economic value other than the services they allegedly rendered as 'finders' in this transaction." Again, the facts completely rebut even an inference that these defendants were to contribute property or services to GAI. The owner of the property was Consolidated of which Porter was the President. The contract (January 11, 1966) provided that the owner, Consolidated, would receive 1,600,000 shares of GAI stock. No property or services were to come to GAI from Matusow, Lester or Seagraves, and nothing was to be paid to them by GAI.

The proof shows that the California property, owned by the Consolidated Sulphur Company, came to the attention of Matusow through Lester. Lester apparently had an oral agreement with Kenneth Porter, Consolidated's President, and Seagraves, to buy the property. Lester agreed with Matusow that if he (Matusow) could sell the property upon terms satisfactory to Consolidated, Lester would receive a portion of the fee paid to Matusow. Seagraves was represented as a principal stockholder of the owning company. Lester's participation in the deal was limited to his personal agreement with Matusow. Thus, Seagraves and Lester can in no sense be termed "finders" as they had no relationship, contractual or otherwise, with GAI.

There is no evidence, and the SEC does not so contend, that the price for the property was not fair or that the bargaining was not conducted at arms-length. The SEC argues that what the seller intended to do with the proceeds of its sale should have been disclosed. But even the SEC is forced to concede that "there is no direct evidence that Mack or any of the other corporate-affiliated defendants had knowledge of the large finders' fees involved in the California transactions." The Commission would infer such knowledge. However, Judge Ryan found to the contrary. Assuming inferable knowledge, the Court's conclusion that "What the seller of the property intended to do or had bound himself to do with them [the proceeds of the sale] played no part in the transaction.", is unassailable as a proposition of law.

The failure of Mack to disclose that which the Court has found he did not know or a failure to cross-examine the

seller as to his intended distribution of the proceeds could not possibly be violations of any section of the Securities Exchange Act.

Arizona

Beard was the sole owner of Basin Mining stock. He had a joint venture agreement with Pagnani and Matusow which provided for their sharing in mining properties owned by Beard on a basis of 4/6 to Matusow and 1/6 each to Pagnani and Beard. The Court found that "There is no evidence that the corporate defendants knew about this private agreement, * * * " and that "there was nothing false or misleading about the 8-K report or the press release to this effect [*i.e.*, that Beard was the owner and the price was 200,000 shares].

When, as and if the Beard property were sold, Beard, quite independently of Mack or GAI, had on March 10, 1966, entered into an agreement with Matusow and Pagnani whereby Beard, the owner, transferred two-thirds of his interest therein to Matusow and one-sixth to Pagnani. Matusow and Pagnani were to "undertake to help promote various mining properties with the view towards a possible sale to private and/or public companies . . ." There is no proof that GAI or Mack participated in negotiating or consummating this agreement. The actual agreement for the purchase of the Arizona property dated April 5, 1966, called for the delivery by GAI to Beard, as owner, of 200,000 shares of GAI stock. GAI did not issue any stock to anyone else as a "finder" or otherwise. Neither Matusow nor Pagnani were under a duty to advise GAI stockholders or the public as to their private agreement with Beard or the

reasons why Pagnani agreed to perform legal services as an attorney for a one-sixth stock interest in the event stock were received as the result of any future transaction.

Nevada

Here the majority deviates so far from the facts that any conclusions based thereon become completely irrelevant to this case. Pacific Sulphur was in fact representing Crofoot, Commonwealth, and Canyon State. The identification of Pacific Sulphur without listing the names of other parties represented by it cannot rationally be distorted into a failure to disclose a material fact in which GAI stockholders might be interested. Were the value to be misrepresented, there might be some basis for complaint but no such claim is made. Again the majority make an assumption that GAI's "willingness to pay intermediaries two-thirds of the price * * * is so unusual" as to raise a question as to the value of the mine. The only difficulty with the assumption is that it is false because (1) the others were not "intermediaries" being paid by GAI for effecting the sale; and (2) no question of the value of the mine is raised—even by the SEC.

Consider for a moment the consequences of the majority's statement that "It must be conceded that imposing on sellers of property or finders a duty of full disclosure to a buyer issuing securities in exchange, with a consequent duty on the latter to publicize material facts so disclosed, would increase the protection afforded investors and traders by the securities laws." Were this the law, or to be the law, no acquisition of property for stock could safely be made. For the buyer to be safe, he would have to obtain from the seller a statement of any and all obli-

gations which the seller might have in connection with the sale, any finder's fees for which he might be liable, a description of the intended distribution of the proceeds and the reasons justifiable at a later date to SEC and federal courts for such distributions. In addition, he would have to refrain from any business transaction involving acquisition of property for stock until he had obtained from the seller the information just mentioned. And he would be forced to discontinue negotiations, no matter how advantageous the deal might be to the stockholders, if the seller refused to disclose his own private affairs by a curt "None of your business." In any event, the business wisdom of seller and buyer could always be attacked by the Commission at some future date if its business judgment differed from that of the parties.

In all three transactions, the positions of buyer and seller are clear as a matter of law and fact. The buyer and seller must agree on a price (here consideration is not in issue). The buyer will desire to be assured that he is receiving good title to the property purchased. If stock is to be issued, he will want assurances which will enable him to determine whether the stock must be registered or is exempt therefrom under the law. The seller's interest will be in ascertaining whether the stock has been validly issued by the purchaser. And in any business transaction, the purchaser will wish to know whether any brokerage or commissions are involved for which he might be liable. However, here there are none.

Under the Commission's theory, many interesting questions would be presented. If the seller were to consist of a syndicate of twelve individuals or companies, must

each of the twelve disclose and justify the syndicate agreement between them made, as in two instances here, before and quite apart from these transactions? If the seller by previous agreement of divorce had undertaken to give half of his property to his ex-wife or possibly with less uxorial compulsion one-third to each of three children, must such an agreement be disclosed? What possible materiality would there be insofar as the value of the property might be affected? Certainly, such recipients (wife or children), to use the Commission's allegation, would have "contributed no property or services of any economic value." But there is no requirement in law that the donees or business associates of the seller make any such contribution. With complete *non sequitur* argument, the SEC states that the allocation between the sellers and those working with them as "finders" is material because "it tends to show, first that the seller was prepared to take far less for the properties than GAI was paying for them and, secondly, that the seller was sufficiently anxious to find a buyer so that he was willing to pay disproportionate compensation to anyone who produced a buyer." No proof whatsoever supports these wholly unwarranted assumptions.

As to the first proposition, there is no proof that the price in GAI stock was not the result of fair arm's-length bargaining. The Commission does not claim otherwise but would explain such lack of proof by the statement that "No one can prove the value of a largely unexplored mining project." But there is no justification for then assuming that the seller's personal arrangements for distributing the sale proceeds had any relation to the true value of the properties or affected in any way the selling price. Fur-

thermore, there is no proof that any of the sellers misrepresented or exaggerated the worth of the properties sold for GAI stock.

In addition, in its pleadings and arguments, the Commission has used misleading terminology to describe the defendants not associated with GAI. In the complaint as to the Arizona property, the Commission refers to Matusow, Pagnani, Lester and Seagraves as being compensated for "services they allegedly rendered as 'finders' in this transaction." The same allegation is made against Matusow, Pagnani and Beard as to the Nevada property and agaist Matusow, Lester and Seagraves with respect to the California property. Affirmatively, the proof is clear and convincing as to the actual status of each of these defendants.

Although Matusow and Beard brought the Nevada property to GAI's attention in April 1966, there is no evidence that they were to receive stock as "finders." In fact, Judge Ryan found that pursuant to a joint venture agreement, Beard and Matusow contributed sales services, and Pagnani contributed legal services. The original agreement provided for a sale price of 300,000 shares plus $4,500,000 in royalties to Crofoot, one of the three owners of the property. Matusow, who received 134,000 shares under the joint venture agreement, guaranteed that the 17,340 shares received by Crofoot as its share of the purchase price would be worth at least $250,000. When the contract was renegotiated, this guaranty was assumed by GAI, and Matusow's commission was reduced to that received by the other members of the joint venture. Initially they were to receive 33,000 shares each, but since the renegotiated deal was less favorable to the sellers, they agreed to accept 15,000 shares

each for their services, leaving the purchase price unchanged. The court below found that "the charge that the Nevada agreement was redrawn in order to conceal the fraud on GAI falls by reason of our finding that there was no fraud and also of its own weight." The record amply supports this finding.

As to the second proposition, from the viewpoint of GAI and the welfare of its stockholders, it would scarcely be in order for the SEC or the courts to make it a condition of every corporate acquisition that the state of mind of the seller, his financial condition, his motive for selling and the adequacy of the price be made the subject of pre-sale inquiry by the SEC. Apparently, Beard, the owner of the Arizona property, needed $50,000 in cash to liquidate a bank debt personal to him. This need may have prompted him to enter into his own agreement with Matusow and Pagnani (Agreement, March 10, 1966). This agreement, however, was quite collateral to the sale-option agreement of March 21, 1966 between GAI and Beard, whereby Beard received the $50,000 for the option—in fact, as to GAI and its stockholders of no relevance whatsoever. If economic pressure motivated his offer and price, it is not for the Commission or the courts to pry into his reasons.[2]

Particularly disconcerting to one who believes that decisions should be based on fact—not fiction—is the judicial willingness as evinced in the majority and concurring opinions not only to distort the facts but also to create for their own purposes hypothetical facts for the existence of which

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[2] History records an offer seemingly quite abnormal, namely, a kingdom in exchange for a horse and yet as events proved such a bargain, had it been consummated, would (momentarily at least) have been highly desirable for Richard III.

not one iota of proof exists. Typical are such statements as "in the Arizona affair * * * the finder defendants received exorbitant fees for the performance of minimal services", and that such fees would "clearly have indicated the property could not be worth the price paid." But there were no fees paid, exorbitant or otherwise. The distribution of the proceeds by the seller was pursuant to a preexisting joint venture agreement wholly unrelated to GAI. As to the "worth" of the property being affected by the joint venture agreement, not even the SEC questions the propriety of the price paid or the value of the property.

Equally disconcerting is the pronouncement of a proposition of law that GAI's officers were aware (an assumption contrary to fact) or should have been aware that finders' fees [there were none] were to be paid and that they were "under an obligation to inquire of the sellers of the property as to what part of the stock issued to them would be paid out as finders' fees and to report this information to the GAI board of directors and include it in press releases and reports." To say that "The finders who were to share in the excessive finders' fees were also under a duty to inform the purchasers of the property of the amount of the fees.", is to place every business and real estate broker in jeopardy unless he (probably in violation of his duty to his principal) advises the prospective purchaser, and if a corporation the stockholders thereof, and the SEC of the business arrangements existing between him and his principal. Only an Alice in a legal Wonderland could conceive of any such proposition.

Officers and directors of corporations are charged primarily with corporate management. If they so mismanage

the corporation that damage results to it, the law provides adequate remedies. Congress has not as yet vested in the Commission general supervision over corporations and the business judgments exercised by their officers in conducting their affairs. And so here, the wisdom of GAI and its chief executive officer in seeking to expand in the field of natural resources was a matter of business judgment. How the judgment was exercised was within the area of internal management. But what GAI and its officers said to its stockholders and to the public, if calculated improperly to affect the price of the shares and public trading therein, would very much be a concern of the Commission. The limits of this concern, however, have been outlined by the Congress in its enactment of Section 10(b). The language states the protective purpose, namely, to safeguard the public and investors against "any manipulative or deceptive device or contrivance in contravention of * * * [Commission rules and regulations appropriate for such protection]." 15 U. S. C. §78j(b). The Commission's understanding of its role is evidenced by the heading of its Rule 10b-5 (17 C. F. R. §240.10b-5) "Employment of Manipulative and Deceptive Devices." Subparagraphs (1) and (3) expressly deal with fraud. Paragraph (2), the key paragraph relied upon here by the Commission, relates to "untrue" statements of "material" facts or the "omission" of such material facts as would be necessary to make the statements "not misleading."

The Commission, of necessity, must as a rule make its investigations after the event. In this case, the warning signals were an increase in price and an increased volume of trading in a low-priced stock [GAI] over a four-month

period. These facts alone might be of little significance in an age in which the slightest rumor of some electronic or equally glamorous-in-the-public-mind discovery has caused scores of publicly listed securities to register fantastic percentage gains.[3] Nevertheless, cause might well be investigated. But without tangible proof of fraud, manipulation or deception, price increase cannot be considered as presumptive evidence thereof.

The record shows that Mack has had a successful and distinguished business career, and is a well-known figure in the corporate and financial field. This, too, is a factor which the court below was entitled to consider. This very fact leads to further consideration of the press release problem. Had a release announced "GAI Acquires Walter S. Mack, Prominent Executive, as President. New Managerial Policies Expected," the investing or speculatively-minded public, confident that his former successors would be repeated, might well have caused a substantial increase in trading volume of GAI and a corresponding increase in price. The following week, a GAI press release might have read, "Mack, new GAI President, announces that he believes future of America lies in its wealth of natural resources. Hopes to acquire mining properties." Thousands, who shared the same beliefs as to our national and natural wealth and with confidence that such an executive would surely succeed, might have determined to entrust their financial future to GAI and, thus, further increase the volume and the price. And if a stock starts from a very low

[3] A glance at the financial section of the New York Times of stocks listed (as is GAI) on the American Stock Exchange (price range 1966) reveals scores of stocks with price fluctuations and price increases of several hundred percent.

price base, the resulting increase percentage in volume and price may well be phenomenal. But just as the millions spent by the giant oil and mining companies with their supersonic electronic devices for probing Nature's most inaccessible areas cannot guarantee against the drilling of dry holes or the failure of a promising vein, so here Mack might well have failed to live up to expectations. Expectations not realized frequently result in lamentations, lamentations in complaints, and complaints in investigations and lawsuits. In retrospect, it might have been better for the press releases to have read, "Mack, successful in corporate management, new head of GAI, but former success no assurance of future results.", and "Mack plans to acquire natural resources but there have been many mining failures since Goldfield-Tonopah days." Certainly these two statements would have been necessary if the accusation of an omission of material facts were to be avoided. And yet the SEC in a *Texas Gulf Sulphur* mood might well have said that in view of the mining experts' favorable reports, optimism should have been radiated rather than gloom.

In matters of probing the earth, it is difficult—if not impossible—to know what to announce. Certain it is that neither courts nor commissions are sufficiently omniscient to formulate the perfect announcement. If optimism is expressed, thus raising the market price, followed by disappointment, the optimism will be considered false; if pessimism is voiced, depressing the market price, and prosperity follows, this announcement would be equally false. In the electronics field, apparently the mere announcement of the manufacture of some gadget that hopefully will be

a part of some device, which will reach some planet other than our own, will send the stock (momentarily at least) almost as high. If the forces of speculative gravity cause the stock to descend, why should the press release not have warned the public that management was not absolutely sure that the device might not be as good as originally expected?

Although the decisions in *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 366 F.2d 456 (2d Cir. 1966) and *List* v. *Fashion Park, Inc.*, 340 F. 2d 457 (2d Cir. 1965), *cert. den.* sub nom., *List* v. *Lerner*, 382 U. S. 811 (1965) are relied upon by the Commission in support of its speculation as to what "a reasonable man would attach importance . . . in determining his choice of action in the transaction in question,"[4] neither case affords precedence or guidance for the problem in issue here. *Holman* was strictly a case of factual misrepresentation by a customer's man of financial information which might well have materially affected the value of the stock and the customer's decision to buy it. The case was summarized as "a high-pressure sales campaign relying in substantial part on materially misleading statements and omissions," justifying an injunction against "further violations of the federal securities laws" (*Id.* at p. 459).

Of a similar character was *Berko* v. *SEC*, 297 F. 2d 116 (2 Cir., 1961), in which a salesman touted a stock of which he had no real knowledge and made completely unfounded representations.

In *List*, the plaintiff was the owner of 5,100 shares of Fashion Park, Inc., which he had purchased for $13.50 per share in January 1959. On November 11, 1960, with the

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[4] Actually a quotation from the Restatement, *Torts* §538(2)(a).

advice of his broker, he offered this stock for sale at $18 per share. On November 16, 1960, plaintiff's broker invited a defendant, H. Hentz & Co., to purchase the stock at $20 per share. The next day the sale was consummated to Lerner, a director of Fashion Park, and other defendants, at $18.50 per share. The plaintiff did not know, nor was he informed, that Hentz was the broker for the director-purchaser or that Fashion Park Management was considering the sale of the company. Negotiations, which had begun on November 22, 1960, culminated on February 3, 1961, whereby Hat Corporation of America offered $50 per share to Fashion Park's minority stockholders. The plaintiff, feeling aggrieved by his $5 per share profit, instead of the potential $36.50 per share profit, claimed that the defendants "had failed to disclose to him material facts in their possession which would have affected his decision to sell the stock" (p. 460). This court there reviewed the cases and texts bearing upon the decision and affirmed the findings of the trial court that the facts known by the purchasers were too remote to have influenced the conduct of a reasonable investor. At the same time, the court recognized the principles codified in section 10b-5, namely, to penalize fraud or sharp dealing of the type disclosed in *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951), *aff'd*, 235 F. 2d 369 (3 Cir., 1956). Thus, *List* presented a case of an actual transaction between a buyer and a seller where the buyer might well be said to have made a decision not to sell had he known the facts which developed a few days after he had concluded his sale. The facts presented here do not bear even a remote similarity to the situation in *List*.

Speed v. *Transamerica Corp., supra,* presented a typical case of the majority stockholder having inside information taking advantage of minority stockholders by purchasing their stock without revealing information which would definitely have affected their judgment as to selling at the offered price.

The improper use of inside information is illustrated in *SEC* v. *Capital Gains Bureau,* 375 U.S. 180 (1963). The publisher knew that the recommendations of his financial service were likely to cause at least a temporary increase in the price of stocks favored. Therefore, to buy these stocks for his own account to reap the benefit of such increase was a violation of section 10b-5.

The fundamental purpose of section 10b-5 and the distinction between fraudulent, manipulative or deceptive practices and instances of corporate mismanagement was recognized in *Birnbaum* v. *Newport Steel Corp.,* 193 F. 2d 461, 464, *cert. den.* 343 U.S. 956 (1952) where this court stated that section 10(b) "was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs * * *."

Birnbaum was thereafter cited and followed by this Court in *O'Neill* v. *Maytag,* 339 F. 2d 764 (1964).

Likewise in *Ruckle* v. *Roto American Corporation,* 339 F. 2d 24 (2 Cir., 1964), the majority directors caused the corporation improperly to issue its stock to one of their number to perpetuate their own control without disclosure of the facts to the entire board.

The Commission's argument concerning omissions and misstatements in the press releases presents many prob-

lems. Obviously, the Commission would not urge that any statute, rule or regulation (at least at the present time) requires that press releases be submitted to the Commission for approval before release or that they be as comprehensive as a prospectus. Of necessity, releases frequently must be brief and, hence, cannot contain all the facts. By way of illustration, a company announces "This Company has today received a $100 million order for war material from the Government." A prospective stock purchaser might well believe that such an order would result in substantially increased profits for the company and, as a result, make his purchase. A contract for such a purchase undoubtedly would be a multi-page document. Would it be misleading not to print the entire contract? As a practical matter, no newspaper would do so as a news item. Should the Company warn the public that a cancellation clause permitted Government cancellation in the event of cessation of hostilities; that a renegotiation clause might affect the ultimate purchase price; or that increased labor costs might materially reduce profits? Yet such possibilities could be material factors in assessing the value of the contract. Furthermore, materiality will vary with the individual. The person who does not have even a grammar school education probably would react quite differently than the holder of a doctorate in economics. Psychology will also be a factor. For every purchaser of stock there must be a simultaneous seller. Their points of view would be as far apart as the poles. The purchaser would be an optimist as to the future of the company; the seller a pessimist. When the optimists outnumber the pessimists in their orders on the Exchange, the stock would most

likely rise; if shares are unloaded by pessimists in excess of current purchase orders, a decline would be expected. The philosophy of the stock market and the causes of its ups and downs have been the subject of learned treatises and speculations by the experts since time immemorial. But the philosophy for courts and commissions should be that they stay within their respective jurisdictions. They exist to protect the public from "manipulative and deceptive devices" including the omission or misstatement of material facts in press releases issued in connection with securities transactions, and hopefully they can recognize (although not here) the difference between information that should be revealed because of its importance to a reasonable investor and information which, while possibly of interest to a speculator, is irrelevant to a reasoned investment decision.

The Commission objects to the following standard of materiality used by the District Court:

> "It is essential that the concealment, omission or untruth be of a material fact. This means that the fact concealed or omitted influenced or should have influenced the issuer in its decision to issue the stock in question, or would under the circumstances influence a buyer in the market." 259 F. Supp. at 109.

The Commission argues that this is a "subjective test" requiring it "to establish not materiality but reliance." While the word "influenced" by itself is unclear, the addition of the phrase "or should have influenced" makes it clear that the court was using an objective test of materiality. In

any event, I would find, using an objective standard,[5] that the seller's distribution plans were not material, and that there were no omissions or misstatements of material facts justifying the grant of a preliminary injunction.

The Temporary Injunction

In the relief granted, the majority reach the apogee of misuse, in my opinion, of injunctive power and thereby

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[5] As we read the cases, a fact is material if it would be important to a reasonable investor because of its relevance to the intrinsic value of a company. See *S. E. C.* v. *R. A. Holman & Co.*, 366 F. 2d 45 (2d Cir. 1966); *Rojen* v. *Ilikon Corp.*, 361 F. 2d 260, 266 (1st Cir. 1966); *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir. 1965), *cert. denied sub nom. List* v. *Lerner*, 382 U. S. 811 (1965); *Hafner* v. *Forest Labs, Inc.*, 345 F. 2d 167, 168 (2d Cir. 1965); *Kohler* v. *Kohler*, 319 F. 2d 634, 642 (7th Cir. 1963); *Cady, Roberts & Co.*, 40 SEC 907, 911 (1961); Rest. Torts § 538(2)(a) (1938); Prosser, Torts 734-36 (3rd ed. 1964); *Harper & James, Torts* 565-66 (1956). See generally Bromberg, Securities Law: Fraud § 8.3 (1967); Note, 55 Georgetown L. J. 664, 671, 682-86 (1967); Ruder, Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur, 61 Nw. U. L. Rev. 872, 885-88 (1967); 3 Loss, Securities Regulation 1463 2d ed. 1961).

In addition, with respect to publicly-traded corporations like GAI the materiality of a given fact will be affected by the probability that disclosure of that fact will have a substantial market impact. See *Hafner* v. *Forest Labs, Inc., supra.* We approve the following statement by Arthur Fleischer in Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289:

> "It is appropriate that management's duty of disclosure under rule 10b-5 be limited to those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed. A more rigorous standard would impose an unreasonable burden on management."

However, "substantial market impact" means a substantial change in the price of the stock for an appreciable period of time, not a momentary change of an ephemeral nature.

deprive the defendants of normal rights to say nothing of their constitutional rights. They are placed under a "temporary" injunction. Temporary until when? Without a date, it can be perpetual. Injunction against what? Against violating the law with respect to stating facts or omitting to state facts regarding securities transactions. What facts or omissions? Such facts or omissions as the SEC in its unrestricted (subject of course to court review) judgment may at some future date so determine in the light of hindsight.

Consider, as is essential, the effect of the injunction against each defendant.

Pagnani

Pagnani is a lawyer. He performed legal services for Matusow and Beard. His fee arrangement with his clients was that his compensation was to be paid in stock (by agreement 1/6 of the shares received by them)—a not unusual arrangement between attorney and client. In complete violation of the attorney-client privilege, the injunction would require Pagnani under penalty of court contempt to disclose all his fees in any transaction involving securities. But disclosure to whom? It would be presumptuous for GAI to ask, or demand to know, how much the seller was paying his attorney. Is a rule of law hereby being created that every attorney, under pain of committing "common law fraud," must reveal to the purchaser the amount of the fee he is receiving from his client, the seller? And lastly, how could the amount of a seller's legal fee possibly be material to those who choose to buy or sell the purchaser's stock? If the price of the purchase be fair

(and it is not questioned here) for the commodity purchased, whether it be a mining property, cold rolled steel, or a trainload of grain, the legal fee paid by the seller to his attorney for drawing the contract not only is personal between attorney and client but would not even be an element which would affect the fairness of the transaction.

Yet the majority, in effect, now tell Pagnani that they single him out as an attorney who henceforth accepts legal fees in stock at his peril unless he tells the buyer the amount of his fee and forces the buyer (how I do not know) to include it in an 8-K report. But why is stock different from cash? If the client received $600,000 and paid Pagnani $100,000, is Pagnani under a duty to exhibit his check to the buyer, examine the next 8-K report, and if it does not appear therein, advise the SEC that there has been an omission of a material fact? The buyer would undoubtedly take the position that the fee paid by the seller to his attorney was of no interest to him. Sufficient refutation of the majority's newly created legal theory should be found in a *reductio ad absurdum* approach.

Beard

Placing Beard under injunction deprives him of engaging in any business transaction for the sale of any of his properties, past, present or future unless he discloses any and all business arrangements in connection therewith as well as his contemplated use of the proceeds. His private contract with Matusow and Pagnani arose out of his personal situation with respect to his $50,000 bank loan. However, future emergencies may well force Beard to contemplate business arrangements which some future court or

the SEC in their overriding business judgments may believe to be "peculiar." The choice would appear to be (1) to proceed at his peril; (2) to try to obtain a declaratory judgment blessing from the courts that they were satisfied with his contractual terms; or (3) a letter from the SEC that subject to many conditions it sees no present reason to object. Again, *reductio ad absurdum* supplies the answer.

Matusow

If Matusow were a finder, he certainly was not a finder employed for a fee by GAI. In the only transaction (Nevada) considered by the majority, his involvement was as a participant in the selling group, i.e., Pacific Sulphur. The injunction against Matusow must be read as an interdict against his being a member of any selling group unless he discloses his interest or his fees to the buyer. In this particular case, Matusow would have had to have disclosed the background of his $250,000 guaranty to Crofoot, the reasons therefor and the negotiations with Crofoot, Commonwealth and Canyon State, which led to the divisions of stock in question.

GAI, Mack, Marren, Stolz

GAI is one of the earlier so-called "conglomerates," namely, a company acquiring other companies in diversified fields.[6] A general injunction of the sort imposed here could

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[6] Great American Industries, Inc., Incorporated October 8, 1928, as Pacific American Associates, Inc., and after changes in corporate title to present name, November 12, 1942.
Corporate Background:
"Company, a venture capital corporation, thru subsidiaries

seriously impair its ability to acquire other companies and place it at a competitive disadvantage. To demand from the seller a commitment as to the seller's proposed use and distribution of the proceeds of the sale would undoubtedly meet with resistance even if the seller knew with exactitude what the use would be. Once the seller had the proceeds, the buyer would have no control of the situation. If, for antitrust purposes, merchandise cannot be sold with prohibited conditions attached, *a fortiori* once the transaction has been completed buyer and seller should be free to enjoy the benefits of their bargain. For the same reasons, injunctive provisions against Mack, Marren and Stolz are wholly unjustified.

The granting of a temporary injunction in this case is contrary to all legal principles recognized in this and other circuits relating thereto. These principles have been expressed as follows:

> ". . . the granting of a preliminary injunction is an exercise of a very far-reaching power, never to be indulged in except in a case clearly demanding it . . . . To justify the granting of such an injunction there must be a showing of irreparable injury during the pendency of the action . . . . It must also appear that the injunction is required to preserve

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(wholly owned except as noted) makes specialized rubber for industrial and manufacturing uses, franchises others to make canned soft drinks, and, since 1966, makes architectural face bricks, clay, and vitrified clay sewer pipes. In 1966 and early 1967 Co. acquired mining claims on properties containing copper and sulphur, and also acquired majority ownership in a company which had exploration rights on properties containing oil, gas, and sulphur." Standard Corporation Descriptions (Standard & Poor), vol. 29, no. 6, sec. 2 (February 29, 1968).

the status quo pendente lite." *Warner Bros. Pictures, Inc.* v. *Gittone,* 110 F. 2d 292, 293 (3rd Cir. 1940).

"'A preliminary injunction is an extraordinary equitable remedy and it will be granted only upon a showing by the applicant that it will probably succeed on the trial and that it will suffer irreparable injury if the defendant is not restrained from certain activity pending the trial.'" *Societe Comptoir De L'Industrie, etc.* v. *Alexander's Department Stores, Inc.,* 299 F. 2d 33, 35 (2nd Cir. 1962).

". . . the plaintiffs failed to make the required 'clear showing of probable success.' *Societe Comptoir, supra.*" *Ames, supra,* 359 F. 2d 777, 779 (2nd Cir. 1966).

And yet the majority are quite willing to take the record upon which Judge Ryan found the facts sufficiently clear to warant the denial of an injunction and, despite the clear proof burden, grant an injunction upon this very record which they characterize as "disorganized" and "so unsatisfactory."

Conclusion

The position taken by the SEC and aided and abetted by the majority is fraught with worrisome consequences. The SEC has advanced "1984"[7] by at least 15 years and casts the ominous shadow of Big Brother over the desk of every executive and over the tables around which directors gather. In a day and age when unreasonable searches and seizures and invasions of privacy give the courts great concern, is it not anomalous that the SEC seeks to pry into the use to which a seller intends to put his sales proceeds? It makes

[7] George Orwell, "1984."

little difference whether it be stock or cash. Is the SEC to have regulatory powers over such use? If so, they should have the power to subpoena every seller to inquire into the intended use of the proceeds. But mere inquiry is of little use unless it can be implemented by some remedy. Using the hypothetical case above-mentioned of a distribution of one-half of the proceeds to a divorced wife, the SEC should be able to decree that the seller's settlement agreement with her was improvident and that the sale should be cancelled or rescinded unless she agreed to take less. How does such an attitude by an administrative agency differ from that of an agency of a totalitarian dictatorship? In a police state, the agents of an agency do not necessarily wear uniforms. And power can be dangerous. Power to protect—here in theory to protect investors—can so easily be turned into power to oppress. The Congress has not chosen to give the Commission this power—it has been assumed by the Commission. The Commission, in turn, without any showing of threatened danger in the future (in fact, the only transactions involved had been terminated) uses the extraordinary remedy of injunction to place a company, its officers and even individuals unrelated thereto under a sword of Damocles, the thread of which can be cut at any time according to the whim and caprice of agents of the Commission. It is no answer to say that it is only an injunction to obey the law because no standards have been set. The defendants under injunction have no way of knowing what item omitted from a release some agent of the Commission will in the future regard as material. Even a statement to stockholders and the public that a company hopes to do well in 1969 is fraught with danger if these hopes are not realized. And, needless to say, a prediction

that 1969 is likely to be a poor year must obviously be a fraudulent scheme to depress the stock. In short, the Commission would have corporations and their executives march in lock step with the Commission in whatever cadence the Commission sets after the march has begun and subject to change at the Commission's exclusive calling. I find it highly anachronistic that in an age when courts and agencies give so much attention to civil rights that rights so much more fundamental (as here) are in my opinion so grossly violated.

Fear and uncertainty pervade corporate and financial officers.[8] And properly so if every utterance is to be made at their peril. Must proposed acquisitions of properties be heralded to the public in advance?[9] If they are and a runaway market thwarts the transaction, are the officers liable for the publicity? If no notice is given, are they to be equally liable for failing to give the public an opportunity to buy?

With the "documented" facts before him, Judge Ryan addressed himself to the only issue before him, namely, on these facts would he have been justified in granting a preliminary injunction in advance of trial to prevent the happening of some currently threatened events which would have resulted in irreparable injury. His conclusion that the proof did not call for the imposition of such a remedy is warranted and should not be disturbed.

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[8] Informal and unofficial though it be, see "Corporate Disclosure and Insider Information"—a Panel Interview. Conference of the Financial Analysts Federation, October 7, 1968.

[9] See discussion in *Sunray DX Oil Company* v. *Helmerich & Payne, Inc.*, 398 F. 2d 447 (10th Cir., 1968), vacating a preliminary injunction.

Opinion of the District Court

SECURITIES AND EXCHANGE COMMISSION, Plaintiff,

v.

GREAT AMERICAN INDUSTRIES, INC., Walter S. Mack, Jerome Matusow, Frederick J. Pagnani, William Thomas Beard, Emanuel Lester, Odie R. Seagraves, Bernard D. Marren, Irving Stolz, Adam Mele, Defendants.

No. 60 Civ. 1734.

United States District Court

S. D. New York.

Oct. 4, 1966.

OPINION

RYAN, Chief Judge.

In this action the Commission seeks to enjoin all but defendant Mele from further alleged violations of Section 10(b) and Rule 10b-5; three defendants, Mack, Marren and Stolz, from further alleged violations of Section 13(a) and Rule 13a-11; and two defendants, Stolz and Mele, from further alleged violations of Section 16(a) and Rule 16a-1 of the SEA of 1934. The Commission also seeks a mandatory injunction directing Mack, Marren, Stolz[1] and Mele to comply with the provisions of the sections claimed to have been violated.

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[1] At the hearing held by the Court on this application, after a reading of Stolz's affidavit in opposition, the Commission withdrew without prejudice, its motion for injunctive relief against defendant Stolz from further violations of Section 16(a) and Rule 16a-1.

Section 10(b) and Rule 10b-5, known as the anti-fraud sections of the Act, declare unlawful among other things the making of any untrue statement of a material fact necessary in order to make the statements not misleading in connection with the purchase and sale of a security. The Commission charges that violation of this Section and Rule occurred when the defendants Matusow, Pagnani, Beard, Lester and Seagraves, "the finder-defendants", together with and aided by the defendants Mack (chairman of the board), Marren (financial vice president and a director), and Stolz (general counsel and a director), "the corporate-defendants", in a series of transactions involving the purchase by Great American Industries, Inc. (GAI) of mining properties, obtained and attempted to obtain from GAI for little or no consideration a substantial number of the shares of GAI common stock paid or to be paid by GAI for the purchase by it of these mining properties. It is charged that in connection therewith the "finder defendants" made false and misleading representations to GAI concerning the true worth and potential of the mining properties while the "corporate defendants" caused GAI to prepare and issue press releases and to file with the Commission and the American Stock Exchange periodic reports on Form 8-K which were false and misleading. These press releases and filings it is charged were designed to and had the effect of (1) concealing from GAI and its shareholders the unlawful diversion of GAI common stock from the company to the "finder-defendants" and (2) causing the price of GAI common stock on the American Stock Exchange to rise and thereby increase the value of GAI common stock to be issued to and owned by these defendants. This was done,

it is said, with respect to three transactions: (1) the acquisition of an option on certain California sulphur properties; (2) the acquisition of certain Arizona copper properties; and (3) the entry into a contract for the purchase of certain Nevada sulphur properties. Essentially, the SEC contends that these acquisitions were obtained by the issuance of substantial quantities of GAI stock and that the owners of the properties involved received a relatively small amount of such stock, the remainder going to alleged "finders".

The alleged violations of Section 13(a) and Rule 13a-11—which Section and Rule require that every issuer of listed securities file periodic reports on 8-K forms recording events relating to corporate affairs—occurred according to the Commission when the corporate-defendants filed the 8-K reports above mentioned.

The alleged violation of Section 16(a) and Rule 16a-1—which Section and Rule require that every officer or director file a statement with the Exchange showing any change in ownership of a security during any one month—occurred when defendant Mele, vice president and treasurer and a director of GAI, failed to file a statement showing a purchase of 2,000 shares of GAI stock on January 12, 1966.

To place this action and this motion in proper perspective it is necessary to spell out what is not charged by the Commission.

It is not charged that the corporate-defendants were to receive any part of the shares issued in payment of the properties acquired and allocated to the "finder-defendants". It is not charged that the sale or contract of sale and the issuance of securities to the Seller of the prop-

erties and the other defendants was not a bona fide sale but a mere vehicle for the issuance of GAI shares to the Seller and the "finder-defendants". Most important, it is not charged that the property acquired in exchange for the shares issued was not worth the value of the shares which were issued in payment therefor. In fact, this is emphasized by the Commission when it says:

> "It is our position that the true value of the mining properties in question is not an issue before this Court. We do not know nor do we allege that these properties are without any value. In the same manner that we do not know the value or potential of the properties, neither do the defendants. It is simply our position that the defendants had no basis in fact for making the statements they did about the properties."

It is charged that "since a substantial disproportionate amount of the company's shares would be diverted to persons who were not owners of the properties" defendants were engaged "in the systematic syphoning off from the company of large blocks of its common stock for little or nominal consideration" in fraud of the issuer. It is also charged that exaggerated claims made by defendants were in fraud of the investing public.

The documentary facts are not in dispute. As charged, the shares of GAI stock were issued or contracted to be issued in the amounts stated in exchange for the properties named. The 8-K Forms and the press releases did report what the Commission charges they did. What is in dispute are the inferences of illegality drawn from these admitted actions by the Commission and its characterization of de-

fendants' conduct as fraudulent and violative of the Statutes involved. In addition, defendants contend that in order to impute fraud to them, the Commission on this motion has done exactly what it has accused them of doing. Defendants charge the Commission has misstated or omitted to state in its papers facts which were known or should have been known to the Commission through its investigation, and which would negate and destroy the inferences drawn by it. Defendants also charge that the Commission has failed to make even a prima facie showing of defendants' guilt of the violations alleged, and that any injunction would be not only unwarranted and unnecessary and an injustice to the defendants but would be more harmful than beneficial to the public.

The historical background of this action is as follows:

According to the Commission, GAI first came to the attention of its investigative staff members during the period between January 13, 1966, the date GAI first issued a press release concerning its acquisition of an option to buy a sulphur property in California, and March 21, 1966, the date GAI issued a press release concerning further developments on the California property and its acquisition of an option to buy a copper property in Arizona. Trading in the shares of GAI on the American Stock Exchange rose from a volume on January 11, 1966 of 53,400 to a volume on March 21, 1966 of 352,100, and the price of the shares increased from a low of 1¾ on January 11, 1966 to a high of 9 on March 21, 1966.[2]

The press release issued by the company on March 21, 1966 described the Arizona mining property as a "new min-

[2] We have taken the quotations from the Commission's affidavits.

ing strike of copper, silver, and gold ore", a "new discovery", a "mine" which would be "in production within 90 to 120 days".

This is the first press release which the Commission says was false and misleading. It has not quoted the full text nor submitted the release in evidence.

At about this time, a report on Form 8-K dated February 14, 1966, covering the month of January 1966, had been filed with the Commission wherein it was reported that GAI had acquired an option to acquire mining claims in California the purchase price of which were 1,600,000 shares of its common stock, plus $250,000 in cash. This is the first 8-K report charged by the Commission to be false and misleading, in that it did not disclose that a substantial part of the shares were to go to "finders" rather than the owner. It has not been fully quoted nor attached as an exhibit.

To continue, the staff, it is claimed, ascertained on inquiry into this market that a number of reports and rumors were circulating in the financial community concerning the value and potential of the proposed mining property acquisitions. When it determined, after speaking with GAI management and through other investigative efforts, that in its opinion no factual basis existed for the reports and rumors and that no justification existed for the rapid rise in the price and volume of GAI shares, the Commission suspended trading in GAI's common stock on March 31, 1966. The Commission states that the purpose of the suspension was to permit clarification of the reports and rumors then circulating.

On April 12, 1966, after discussions with the staff, GAI,

at the urging of the staff, issued a release "clarifying" that of March 21, 1966, as follows:

> "* * * It is not now known whether or not there is a commercially mineable ore body at the property. The Company has no reports establishing the existence of such an ore body (at the Arizona property). Only limited exploratory work has been done thus far, and further exploration is intended."

The trading ban was lifted on April 15, 1966, and trading was resumed.

The Form 8-K report, dated April 11, 1966, covering the months of February and March 1966, and received by the Commission on April 13, 1966, did not in its opinion conform to this press release of April 12, 1966 in that it referred to the property as a "mine" and indicated that it could be operating within "90 days", and anticipated that it might be operating at profits ranging from $50,000 per month to $3,000,000 per year. When the Commission expressed its dissatisfaction with this statement and pointed this out to defendants, the following day, April 14, 1966, an amended report was filed, which stated:

> "* * * It is not now known whether or not there is a commercially mineable ore body at the property. The Company has no reports establishing the existence of such an ore body. Only limited exploratory work has been done thus far, and further exploration is intended. * * *"

This amended report was not disclosed to the Court by the Commission in its original papers or in its argument.

It was only after defendants had brought it out that the Commission referred to it in its reply brief.

This report also contained a statement that on April 5, 1966 GAI had acquired all the stock of the Arizona corporation "in exchange for 200,000 shares of GAI, Inc. common stock."

This is the second 8-K report which the Commission points to as false and misleading, in that it failed to disclose the substantial participation of finders in the shares received by the owner. Again, it has not been quoted in full or evidenced by an exhibit.

It appears that within the week after trading was resumed the price rose from a low of 11 on April 15, 1966 to a high of 14⅝ on April 20, 1966. During the following week, however, the price fell to a low of approximately 8 on April 26, 1966.

On April 27, 1966 GAI issued another press release concerning all three properties, the California, the Arizona and Nevada mines. It stated as to the first that:

> "additional drilling and exploratory work is now being carried on by the mine owners on the 340 acres of sulphur bearing deposits in California under option to Great American but results on this work will not be available for about 60 days";

as to the second that:

> "With regard to the copper and silver property called Copper Stack Mines recently purchased by Great American in Arizona, Mr. Mack stated that the machinery and equipment was now being ordered which should put this property into production in about 90 days";

and as to the third that:

> "Great American Industries, Inc., through its chairman, Walter S. Mack, just announced that it purchased 20 mining claims covering approximately 3,500 acres containing elemental sulphur deposits in the Kamma Mountains, Humboldt County in Nevada, for 300,000 shares of Great American Industries common stock, which are to be taken by the sellers for investment and not for public distribution."

This is the second press release charged by the Commission to be false and misleading.

When the Commission's staff complained, a further release was issued, on April 28, 1966, which read in part:

> "With regard to the California sulphur claims on which Great American acquired the purchase option in January, 1966, the engineering firms of Behre Dolbear & Co., and Arthur D. Little Inc., have reported to the Company that their investigations of the claims have not indicated sufficient promise of commercially mineable ore bodies to justify further expenditure by Great American on such investigations. Consequently, the Company has terminated the work by these engineering firms and will concentrate its efforts on the Nevada claims.
>
> "The statement in its release with regard to machinery orders for the plant at the Copper-Silver Gold properties in Yavapai County, Arizona and that the plant is expected to be in production within 90 days does not alter the statement we previously made on April 12, 1966 that it is not now definitely established whether or not there is commercially mineable ore body at the property."

It does not appear that the Commission found fault with the statements made regarding the Nevada property.

This "clarification" was not mentioned in the moving papers and was brought to the attention of the Court on the argument.

Trading was again suspended on April 29, 1966. The order of suspension recited that it was predicated on serious questions as to the accuracy and adequacy of information relative to corporate acquisitions and mining property in which GAI holds options.

It is further stated by the Commission that during its investigation, which still continues, the Commission uncovered further false and misleading statements in the 8-K reports, in that they did not disclose that "almost one-half of the shares to be issued for the purchase of the three purported mining properties were to go to a group of finders headed by defendant Matusow."

On May 11, 1966, an 8-K Form was filed reporting the same information on the Nevada property as that which had been reported in the April 27, 1966 press release. Attached to this report was a "feasibility study of the sulphur deposit owned by the Pacific Sulphur Company" made by Canyon State Mining Corporation of Nevada. The falsity here charged is the failure to disclose the participation of the finders in the 300,000 shares of GAI and to disclose that the author of the feasibility study was "actually one of the owners and sellers of the Nevada property, and that the named owner, Pacific Sulphur Corporation, was an entity formed to take title to the property on behalf of the owners and the defendants Matusow, Pagnani and Beard and to be

the vehicle through which the conveyance to GAI was to be effected."

In addition, the Commission has charged the defendants with a revision of the agreement on this Nevada transaction after the commencement of its investigation in order to conceal the fraud that was being perpetrated upon GAI and its stockholders.

It appears that on June 13, 1966, three days before the institution of this action, a further 8-K Form was filed with the Commission, which according to defendants gave more detailed information concerning the Nevada acquisition. The Commission does not dispute this, and since neither side has placed this report in evidence we assume it is so.

From these alleged "repeated unlawful filings" the Commission concluded that the corporate affiliated defendants were unwilling to comply with the Federal securities law, and that together with the "finder-defendants" they had defrauded the Company and its stockholders, making injunctive remedy necessary.

We turn to the first transaction—the option to acquire certain sulphur property in California—where defendants Mack, Marren and Stolz are charged with fraud in that they did not disclose that out of the 1,600,000 shares of GAI common stock issued in payment to Porter, the owner, 600,000 of these shares were to go to Matusow, Lester and Seagraves. Apart from the question of materiality as it affected GAI stockholders and might influence market purchasers, it is plain that unless these defendants knew of the division which was to be made of the stock paid by GAI by the owner among the other three, they could not be

under a duty to disclose it. Here the Commission has changed from its original position and now states in its reply brief that "there is no direct evidence that Mack or any of the other corporate-affiliated-defendants had knowledge of the large finders' fees involved in the California transactions," but states that such knowledge can be inferred.

We find on the record before us that there is no direct evidence to establish that these defendants did then know of the finders' fees to be paid by the owner, Porter.

The documents show that 1,600,000 shares was the purchase price agreed on for the property, plus $250,000 on the option. Originally, Porter had asked for 1,800,000 shares and $300,000 on the option. The testimony of Porter before the Commission was that he had said nothing about his private arrangements with Matusow and the others, and that probably the corporate people did not know of them.

To lend support to its charge that Porter asked of Mack only one million shares for the property, the Commission quoted an extract of Porter's testimony but did not quote Porter's further testimony which gave credence to the three defendants' sworn affidavits that they knew nothing about the allocation of GAI shares. Because Mack knew Matusow as a broker, or as a finder, who had called his attention to the property and introduced him to Porter, and because Matusow, Lester and Seagraves participated in the negotiations Mack had with Porter over the sale of the property, the Commission concludes that Mack knew what their arrangement was and wilfully concealed it in order to induce the issuance of the shares by GAI for the benefit of Matusow, Lester and Seagraves. Assuming this was so—

and we have found to the contrary—if GAI received value for its shares it is difficult to see where the fraud lay, since it has not been charged that the identity of those receiving the stock was any part of the consideration or affected the value of the shares. What the seller of the property intended to do or had bound himself to do with them played no part in the transaction.

But, to return to the facts, in view of the Commission's concession that there is no direct evidence that any of the defendants knew of the allocation of the shares and in the absence of any circumstantial evidence proving such knowledge, the 8-K Form of February 14, 1966 stating 1,600,000 shares as the purchase price for the California sulphur property, we find was accurate and true.

As for the press release of April 27, 1966, the Commission charges that the statement that the drilling and exploratory work was being carried on by the "mine owners" on the California property was false and misleading because, in fact, GAI had prior to that time decided on the basis of its engineers' reports[3] to discontinue further exploratory work and not to exercise its option to purchase the property. While it might be argued that the statement was not complete in that it did not disclose the advice of GAI's experts that it discontinue further work because the results were not what the seller had represented them to be, it is found that it was true and accurate in all other respects. The record shows that Mack did have an agreement dated April 13, 1966 with representatives of the owner in

[3] It is undisputed that Mack had hired recognized mining and drilling engineers to inspect and drill the property and report to him as to its potentialities.

which they agreed to continue drilling and exploratory work according to their system, to which GAI would contribute an additional sum of money, that the results would not be known for about 60 days and that GAI's option was extended for six weeks. The option expired at the end of this period, and the contract has not been consummated.

On these undisputed facts, it is difficult to find support for the Commission's charge that on the California transaction the defendants were guilty of misleading and false statements in the 8-K forms or in their press releases.

Factually the Arizona transaction differs from the California negotiations in that here it appears probable that the corporate-defendants knew that others besides the named seller were to receive some of the GAI shares, but it still does not appear that they knew the amounts they were to receive.

The charge is that the 8-K report filed April 13, 1966 was false and misleading in that it recited that GAI had acquired the Arizona property from Basin Mining Company in exchange for 200,000 shares whereas in fact the named seller and stockholder Beard[4] was to receive only 33,000 of these, and the balance were to go to Matusow, Lester, Seagraves and Pagnani; that attached to the report was a document which "purports to be an agreement for the sale of the Arizona property at a price of 200,000 shares", and what "purports to be an investment letter" signed by Beard as to the 200,000 shares. We here note that what "purports to be an agreement" is the contract of sale be-

[4] Beard was a driller and mining engineer who had worked in the California property and had been recommended to Mack by Porter and approved by Mack's expert, Behre, Dolbear & Co.

tween GAI and Beard and that it does recite that 200,000 shares is the price, but because it also recites that Beard is the stockholder who owns all the shares of Basin with others, less than ten in number, who have a beneficial interest, the Commission says that the corporate-defendants knew that 167,000 shares were to be paid over to the others.

The evidence before us shows that at the closing Marren inquired as to the identity of the people described in the contract as beneficially interested and was told by Beard that they were associates of his, but that he did not disclose their names or the allocation to be made of the stock, and that Beard exhibited a certificate showing that he was the sole owner of the Basin Mining stock and that the investment letter came from him alone. The fact was that Beard, Pagnani and Matusow had a joint venture agreement providing for their sharing in mining properties owned or controlled by Beard; Matusow to contribute sales services and Pagnani his legal services to a ratio of 4/6 for Matusow and 1/6 and 1/6 each to the other two, Beard and Pagnani.

There is no evidence that the corporate-defendants knew about this private agreement, although they knew Matusow as a finder who was connected with Beard and had been rather active in the negotiation of this deal, and they knew Pagnani as Beard's attorney. They undoubtedly knew that Matusow and Pagnani were to be compensated by Beard.[5]

In any event, the corporate defendants dealt with Beard exclusively as the owner and seller; the price was 200,000

[5] Matusow and Pagnani say that the defendants knew them as the persons beneficially interested with Beard. Beard says he disclosed the amount of shares he was retaining. Defendants deny this.

shares, and there was nothing false and misleading about the 8-K report or the press release to this effect, even if they did have ground to believe that Beard was not to keep the whole of the purchase price.

The other charge of falsity contained in this 8-K report filed April 13, 1966, it is alleged, was that there was no basis for the representations made concerning the Arizona property. The evidence here is that attached to this 8-K report were four reports—two from Beard, the owner, who also was a mining engineer of considerable experience and good background, one from Arthur D. Little, Inc., a recognized expert in the field of mining engineering, which report supported Beard's analysis of the value of the property and stated that it was favorably impressed with Beard's sincerity and knowledge and recommended an association with him, and a report by Van Dornick, another recognized expert in the field, with excellent background. All of these reports gave basis for the statements made concerning the property by the defendants in the 8-K Form report. What more should be required before a business executive would feel safe in acting on experts' reports is not disclosed. In support of what is really a criticism by the Commission of Mack's business judgment in following the four reports of his experts its only proof here is an affidavit from the Commission's Chief Mining Engineer, who apparently does not share the optimism of the other three experts and who states that in his opinion their predictions as to the property were without basis. He may be right, but we do not now so decide, nor would we on the proof before us. Even if the Commission should be found correct, it does not mean that the corporate-defendants were guilty of false or mis-

leading statements in adopting the views of their experts.

The fact that the corporate-defendants modified the wording of the 8-K Form on the day following at the urging of the Commission is not an admission of guilt but rather the act of prudent businessmen to avoid unnecessary conflict and perhaps litigation with a Government agency charged with regulating their activities.

There was nothing false in the press release of April 27, 1966 reporting the ordering of machinery and equipment in order to put the property into production. This was entirely true, for Mack had entered into such an agreement with Beard on April 5, 1966.

The facts around the Nevada transaction are that on April 18, 1966 this sulphur bearing property was called to the attention of Mack by Beard and Matusow. After an inspection by Mack and his mining expert Behre and a favorable report on it recommending exploratory drilling, Pagnani, under his joint venture agreement with Beard and Matusow, drew the sales contract between GAI, as purchaser, and Pacific Sulphur Company, as seller. This contract (not before the Court) we are told provided for the acquisition of all the stock of Pacific Sulphur in exchange for 300,000 shares of GAI plus a royalty payment of $4,500,000 to Crofoot Lumber Co. The property, it appears, was really owned by three interests—Crofoot Lumber Co., Commonwealth Silver Co. and Canyon State Mining Co.—which had formed Pacific Sulphur Company for this transaction. Under the sale agreement the GAI shares were to be apportioned: 17,340 to Crofoot and 41,330 each to Canyon and Commonwealth and the balance of 200,000 shares to Matusow and Pagnani and Beard (4/6, 1/6 and 1/6 accord-

ing to their agreement). In addition, Matusow guaranteed Crofoot a value of $250,000 on the 17,340 shares received by it. The closing scheduled for April 20, 1966 never took place because of the trading suspension and also because in the meantime a lawsuit had been started by one claiming that it had a contract of purchase with Crofoot. After further negotiations, on June 3, 1966, a new agreement was drawn providing for the same price of 300,000 shares of GAI stock but to be differently apportioned—Matusow, Beard and Pagnani to receive 15,000 shares each and the balance to go to Crofoot to increase its allocation to 44,232 shares and Canyon and Commonwealth to 105,384 shares each. The other changes were that GAI assumed Matusow's guarantee to Crofoot that the stock it received would be worth $250,000; the sellers were to indemnify GAI against the lawsuit brought and in addition were to assume 50% of the expense of exploration up to $100,000. It was also provided that the shares to be issued to them by GAI were to be proportionately reduced in the event that the property returned less than 5 million tons of sulphur ore. This is apparently the agreement which is on file with the Commission now. The closing of this revised agreement was fixed for July 15, 1966 and has not taken place, because of the suspension.

As indicative of the fraud the defendants were bent upon perpetrating, the Commission points to the fact that although GAI took over Matusow's guarantee to Crofoot, the shares which he was formerly to receive because of this guarantee were given not to GAI but to the sellers. Defendants reply that the change of guarantors had nothing to do with the purchase price which was fixed at 300,000 shares, irrespective of its allocation, and that in exchange for the

guarantee GAI received further benefits. Viewed in the light of the proof before us whether the revised arrangements were or were not beneficial to GAI is not the concern of the Commission or of this Court. With the Commission's concession that it is not questioning the value of the properties acquired in exchange for the shares issued—we must assume in this matter that the Nevada property was worth the 300,000 shares, irrespective of how many persons were to receive them—the failure of the defendants to disclose the allocation of the shares paid was not a failure to disclose the true purchase price demanded by the sellers. Obviously, the same is true concerning the other properties.

[1, 2] It is essential that the concealment, omission or untruth be of a material fact.[6] This means that the fact concealed or omitted influenced or should have influenced the issuer in its decision to issue the stock in question, or would under the circumstances influence a buyer in the market. This the Commission has failed to establish. Because the "finder-defendants" were to receive a substantial and even disproportionate part of the shares issued to the owner and seller of the property for what it considered to be little or no consideration, the Commission has assumed that the concealment of their identity and the extent of their participation was the concealment of a material matter; and since this took place in connection with the issuance of stock, it has concluded that the issuer was defrauded and the statute violated.

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[6] Of course, there can be no concealment, omission or untrue statement unless the fact is within the knowledge of the issuer or the statement is so recklessly made as to constitute a fraud.

[3] In view of the fact that the Commission does not charge that the failure to disclose the participation affected the value of the property received by GAI in exchange for its stock, it must charge that had GAI known that the stock it issued to the nominal seller was not going to be retained by him but was going to be distributed among several other people it would not have issued it, irrespective of the value of the property. This it has not done, and there is not one scintilla of evidence to this effect. Consequently, assuming that defendants knew all the details of the seller's arrangements with the "finder-defendants" and did not disclose them, they would not be guilty of a fraud in connection with the issuance of the stock (List v. Fashion Park, 2 Cir., 340 F.2d 457).

[4] Whether or not, as the Commission charges, these finders, Matusow, Seagraves, Lester and Pagnani, gave any consideration in exchange for their shares was, under the circumstances here present, of no concern to GAI, which dealt with the named seller alone. There is no evidence, and no charge is made, that GAI or the corporate-defendants had any contractual arrangements disclosed or undisclosed with any of these finders. On the contrary, it appears from the record before us the arrangements were strictly among the finder defendants themselves, and this included the consideration they extended for the stock they received.

We find specifically that the Commission has failed to establish on this motion that defendants knew the arrangements which existed between the seller and the finders on the California and Arizona properties. We also find that even if they had known, as they unquestionably did in the Nevada transaction, their failure, under the circumstances

shown before us, to disclose them in the 8-K reports and the press releases did not constitute a violation of Section 10(b) or Rule 10b-5.

The charge that the Nevada agreement was redrawn in order to conceal the fraud on GAI falls by reason of our finding that there was no fraud and also of its own weight. If defendants were out to fraudulently induce GAI to issue its shares, as is charged, a change in the reallocation of the same number of shares would still be a rather obvious fraud. Perhaps the investigation did make defendants take a harder look at their bargain, but this would not be evidence of consciousness of guilt. Besides, the Commission has not disputed the reasons advanced by all defendants for the revision of this agreement.

[5] We also find that it has failed to establish that the statements contained in the press releases and the 8-K Forms concerning these properties were knowingly false and misleading or made without basis in fact, in violation of Section 10(b) and Rule 10b-5.

While this conclusion would not foreclose a finding that the 8-K reports by reason of inaccuracy or incompleteness did not comply with the filing and reporting requirements of Section 13(a) and Rule 13a-11, the Commission has failed to establish any such violation. The requirement of the Rule is simply that certain events specified in the Form, such as the acquisition or disposition of assets and increases in the amount of securities outstanding be reported on a current basis, in order to furnish information necessary to enable investors to make informed investment decisions. The conclusion that this purpose was thwarted by misleading and

inaccurate reports which concealed an alleged "syphoning off" of GAI stock and caused investment decisions to be made on misleading and insufficient information is not supported by the evidence presented on this motion.

[6] We come then to the violation of Section 16(a) and Rule 16a-1 charged against defendant Mele. There is no question that he failed to report his purchase on January 12, 1966 of 2,000 shares of GAI securities while he was a vice president and treasurer and a director of GAI. In addition to this charge, Mele admits that he failed to file similar reports of six different transactions in 1965 and three in 1966 totaling some 10,000 shares of GAI stock. The purchase on January 12, 1966 was at a low price of $2 per share preceding the announcement of the acquisition of the option on the California property; a subsequent sale in April 1966 was at the increased price of $11 per share.

The deliberateness of Mele's conduct is attested to by the fact that although the Commission had commenced its investigation in March 1966 and had instituted its suit on June 16, 1966, it was not until June 30, 1966 that he filed the required reports and by the further fact that he lied to Mack when queried as to whether he had bought or sold any GAI stock since January 1966.

In view of the position Mele held with the corporation and his background of similar positions for the past 20 years, his attempted explanation that he did not know that he had to report transactions which he carried on in a street name is not only incredible but adds to his culpability, since it made the transactions more difficult to trace. That he was well aware of the requirements of the law is evidenced by the fact that on other occasions he had reported pur-

chases of GAI securities. His repeated violations of the law, coupled with his belated and enforced compliance require that he be directed to comply with the filing requirements and be enjoined from further violations of Section 16(a) and Rule 16a-1, and an order so providing will be entered.

In all other respects, on the record now before us, the motion for a preliminary injunction is denied. Settle order on notice.

APPENDIX C

Conflicting Opinion

FIRST TRUST & SAVINGS BANK OF ZANESVILLE, OHIO

v.

FIDELITY-PHILADELPHIA TRUST CO.

No. 11238.

United States Court of Appeals,

Third Circuit.

Argued April 6, 1954.

Decided June 28, 1954.

Rehearing Denied July 20, 1954.

Before GOODRICH, KALODNER and HASTIE, Circuit Judges.

GOODRICH, Circuit Judge.

This case presents the often recurring situation of two people who, doing business in the ordinary course, have been fooled by a swindler. The swindler disappears or goes to jail. Which of the two parties is to bear the loss his rascality has occasioned?

The trial court made very full findings of fact on the history of the dealings among the parties and also the facts

of the immediate transactions out of which this suit arose. Those extensive findings need not be repeated here. See D.C.E.D. Pa. 1953, 112 F.Supp. 761.

Our set of operative facts gets down to this comparatively simple case. A bank's customer (the bank being the defendant, Fidelity-Philadelphia Trust Company) brings to the bank what purports to be the negotiable promissory note of a whisky distiller. This note is accompanied by what purports to be a negotiable warehouse receipt evidencing a deposit of whisky, which is to be collateral security for the note. Both the note and the warehouse receipt are, in fact, spurious. The customer (Philadelphia Acceptance Corporation, hereafter called PAC) does two things. First, it deposits with the bank in its trust department the purported warehouse receipt, for which the bank issues a safekeeping receipt and puts the document in a file. This is a bailment for the benefit of PAC and the purchaser of the promissory note. The charge made by Fidelity for the service is barely sufficient to cover its expenses in connection therewith. Second, the customer, PAC, leaves with the collection department of the bank a draft drawn by itself in its own favor on the plaintiff, The First Trust and Savings Bank of Zanesville, Ohio, (Zanesville), which is to be the purchaser of the note. Forthwith defendant Fidelity credits its customer with the amount of the draft and charges PAC interest until the transaction is closed. It is closed by Fidelity's forwarding the draft, note and safekeeping receipt to Zanesville. This bank in turn sends Fidelity a check payable to Fidelity's order and drawn on the Chase Bank in New York. In due course of time this check clears and Fidelity is thus reimbursed for the credit it has made to its cusotmer.

The first problem is: Does this transaction make Fidelity a seller within the terms of the Securities Act of 1933?[1] It should be noted that what was done here is very similar to what goes on in thousands and thousands of cases where a bank advances funds to its customer upon having endorsed to it the customer's draft on a third party, accompanied by a negotiable bill of lading or warehouse receipt. The only addition here is the keeping of the purported warehouse receipt in the files of Fidelity, not because Fidelity wanted it, but because of the arrangement made between PAC and Zanesville.[2] The situation differs also from the sight-draft-

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[1] "Any person who—

"(1) sells a security in violation of section 77e of this title, or

"(2) sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of section 77c of this title), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C.A. § 77*l*.

[2] Originally, PAC would forward the warehouse receipts directly to Zanesville. Because of the paper work required by this arrangement, a Zanesville teller asked PAC's agent to suggest a less cumbersome method of handling the receipts. He suggested that PAC deposit the receipts with defendant, which in turn would forward to plaintiff a safekeeping receipt, usually covering several warehouse receipts. Zanesville agreed to this procedure.

bill-of-lading-attached transaction in that here PAC's draft was accompanied by the distilling company's note, which was the supposed thing of value given for the loan.

[1] If this set of facts constitutes Fidelity a seller under the Securities Act, it seems to us inevitable that every bank which advances money to a customer upon a sight draft and negotiable bill of lading is also a seller. True there are one or two additional facts in this case. Fidelity here stored in its safekeeping files the purported warehouse receipt. But we do not see that this fact affects the relation of the parties to the collection transaction. The deposit of the receipt was a convenience to PAC and Zanesville, for it made easier the substitution of new receipts and notes when this was in order. It was frequently in order, for during the years 1939 to 1950, Zanesville had made 220 purchases of distillers' notes from PAC. The plan for such deposit with Fidelity was worked out by PAC and Zanesville, as shown in the recital in footnote 2.

It is also true that Fidelity sent some information to Zanesville at one time about its customer, PAC, at Zanesville's request. We do not see how that adds anything to the concept of Fidelity as a seller. The information was gratuitously given. Fidelity did not urge by intimation or express statement that Zanesville should act upon the information. Whether the letter had other legal consequence we shall discuss later.

The words of the federal Securities Act of 1933 are very, very comprehensive indeed. The subject matter includes documents such as drafts and notes. By express wording "sale" is pretty broadly defined. Here is the language: "The term 'sale', 'sell', 'offer to sell', or 'offer for sale'

shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value * * *." 15 U.S. C.A. § 77b(3).

[2] Furthermore, it can hardly be denied that when a bank takes a document for collection advancing to its customer credit prior to the actual collection being made, the bank then becomes at least a security owner. Maryland Casualty Co. v. National Bank of Germantown & Trust Co., 1936, 320 Pa. 129, 182 A. 362. And see Note, 22 A.L.R.2d 479 (1952). And when it endorses the instrument, on which it thus advanced credit, to another bank by the general endorsement "pay any bank, banker or trust company," and gets its money, has it not passed its interest in that document along to him who pays the draft and gets the supposedly valuable bill of lading, warehouse receipt or note accompanying the draft? And if that is so, why have we not been pushed into the startling conclusion that every bank that makes an advance on an instrument left with it for collection, and passes that instrument on to someone else, has become a seller under the terms of the federal statute, if the transaction is one in interstate commerce?

[3] We think that we do not need to reach this startling conclusion, at least on the facts of this case. In this we are supported by the clearly established law of Pennsylvania with regard to the relation of a bank and its depositor. It is true that in construing the federal statute we are not, of course, bound by state law concepts. But in deciding whether Fidelity has done things which bring it under the terms of a federal statute, we look to the law of Pennsylvania to see the state law consequence of business dealings between

PAC, a Philadelphia customer, and Fidelity, a Philadelphia bank.

In the case of each of the worthless notes involved in this litigation, PAC, as stated above, had drawn a draft in its own favor upon Zanesville. These drafts were endorsed to the order of Fidelity, without qualification. Such endorsement is a special endorsement under section 34 of the N.I.L.[3] and is in no sense a restrictive endorsement. Ordinarily when a person is given physical possession of a negotiable instrument thus specially endorsed to him he becomes the owner. But in Pennsylvania this matter is expressly covered by a statute of 1931 and that statute is important enough to quote here:

> "Except as otherwise provided by agreement and except as to subsequent holders of a negotiable instrument payable to bearer or indorsed specially or in blank, where an item is deposited or received for collection, the bank of deposit shall be agent of the depositor for its collection and each subsequent collecting bank shall be subagent of the depositor but shall be authorized to follow the instructions of its immediate forwarding bank, and any credit given by any such agent or subagent bank therefor shall be revocable until such time as the proceeds are received in actual money or an unconditional credit given on the books of another bank, which such agent has requested or accepted. Where any such bank allows any revocable credit for an item to be withdrawn, such agency relation shall, nevertheless, continue, except the bank shall have all the rights of an owner

[3] Purdon's Pa.Stat.Ann. tit. 56, § 85; to be superseded by the Uniform Commercial Code, effective July 1, 1954, 12A P.S. § 1-101 et seq.

> thereof against prior and subsequent parties to the extent of the amount withdrawn. * * *" Purdon's Pa. Stat.Ann. tit. 7, § 213.

A later section of the same statute provides:

> "Where a deposited item is payable to bearer or indorsed by the depositor in blank or by special indorsement, the fact that such item is so payable or indorsed shall not change the relation of agent of the bank of deposit to the depositor, but subsequent holders shall have the right to rely on the presumption that the bank of deposit is the owner of the item. * * *" Purdon's Pa.Stat.Ann. tit. 7, § 215.[4]

[4] Now it is true that to become a "seller" under the Securities Act one does not have to be the owner of that which he "sells." A broker can, under some circumstances, become a "seller." Cady v. Murphy, 1, Cir., 113 F.2d 988, certiorari denied, 1940, 311 U.S. 705, 61 S.Ct. 175, 85 L.Ed. 458, (seller's broker); Boehm v. Granger, 1943, 181 Misc. 680, 42 N.Y.S.2d 246, affirmed without opinion, 1st Dept., 1944, 268 App.Div. 855, 50 N.Y.S.2d 845, (buyer's broker). On the other hand, Professor Loss says that there are vari-

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[4] These two sections will be superseded by the Uniform Commercial Code, which becomes effective July 1, 1954 in Pennsylvania. The Code provision reads as follows:

> "Unless a contrary intent clearly appears, a depositary bank takes an item for collection regardless of the form of indorsement or lack of indorsement and even though credit for the item is subject to immediate wihdrawal as of right." Purdon's Pa.Stat.Ann. tit. 12A, § 4-201.

See also the comment to that section. The rule likewise represents the case law in Pennsylvania. See Lipschutz v. Philadelphia Savings Fund Soc., 1933, 107 Pa. Super. 481, 164 A. 74, and cases cited therein; Foster v. Federal Reserve Bank of Philadelphia, D.C.E.D.Pa.1939, 29 F. Supp. 716, affirmed 3 Cir., 1940, 113 F. 2d 326.

ous kinds of mechanical activities which do not come under the statute and his extensive experience in this field gives his view importance, especially in the absence of case law to the contrary.[5]

[5] The agent for collection under the Pennsylvania law is not a purely "mechanical" forwarder. He is not a seller. Nor is he a broker. But we think that the clear and insistent characterizing of the collecting bank under Pennsylvania law as agent supports our conclusion that Fidelity in receiving drafts from PAC and forwarding them for collection to Zanesville did not become a seller under the Federal Securities Act.

Assume now that what is said above is incorrect, and that we are driven to the conclusion that Fidelity was a "seller," under the Securities Act. What has it done which will place liability upon it? Or, to put the matter in a different way, in statutory language, has it met the burden the statute places on it to prove that, if there was an untruth or omission, it "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission * * *."[6] There are two points in this connection made by Zanesville.

One of the points has to do with a letter which the credit manager of Fidelity sent to Zanesville back in March, 1949.[7] That letter was in answer to an inquiry made of Fidelity by Zanesville concerning the credit of Philadelphia Acceptance Corporation, which was a customer of Fidelity for other

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[5] Loss, Securities Regulation 341 (1951).

[6] See note 1, supra.

[7] The transactions out of which the spurious notes and warehouse receipts arose were consummated in July, 1950.

things than the kind of transaction described above. Fidelity's answer started by announcing in big type that the information was gratuitous and given as a business courtesy.[8] We make nothing of that. A man may become just as much liable for the consequences of his lie if he does it for nothing as if he gets paid for it. Restatement, Torts, § 552, comment *c*.

Appellant makes much of the point that the financial affairs of Mr. Collom, the president and perhaps sole shareholder of PAC, were not mentioned in Fidelity's letter. We make nothing of this either. The inquiry was about the corporation. Furthermore, we do not know whether tax liens which are said to have existed against Mr. Collom at the time were or were not subsequently satisfied. Nor do we know about a judgment which was said to be outstanding against him at the time—whether it was reversed, satisfied or what. At any rate, the inquiry was about the corporation and it was the corporation which was Fidelity's customer.

[6] There is more to be said about the letter however. It went on to say that PAC's account was handled in a satisfactory way and gave an explicit statement about an average five-figure balance. This five-figure statement was true but it was also found as a fact that twelve times in the two months before the letter was written, PAC had had overdrafts amounting to sums from several hundred dollars to over thirty-six thousand dollars. We do not go with the argument that when a man says something that is literally true he has told the truth even though he does not tell the

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[8] "This information is furnished as a matter of business courtesy on the understanding it is confidential and no responsibility therefor attaches to this bank or any of its representatives."

other things which would qualify the statement made. "To tell half a truth only is to conceal the other half."[9] But the saving grace of the letter is the last sentence. The defendant's credit manager said: "A condensed balance sheet exhibited to us last year indicates that the net worth of the Philadelphia Acceptance Corporation is limited and is substantially less than outstanding obligations." That, we think, is enough. The sum total impression from the letter is truthful and certainly gives warning to one who is prospectively going to extend credit to the concern inquired about.

[7] The other incorrect representation alleged to have been made by Fidelity is the statement on the safekeeping receipt that such and such warehouse receipts had been received and placed in the safekeeping file. If Fidelity had a duty to investigate the genuineness of these documents, quite obviously it did not fulfill that duty. Likewise it did not use reasonable care to fulfill this duty, if it existed, because a small amount of inquiry would have revealed whether the distillery had the officers whose names appeared on the notes and receipts and also whether the receipt in fact had been issued by the warehouseman. No such inquiry was made. It is also true that Zanesville could have found out with equal ease and convenience, or at least almost equal ease and convenience, about the genuineness of the documents. So our question becomes: Does a bank, when it

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[9] Mitchell, J., in Newell v. Randall, 1884, 32 Minn. 171, 172, 173, 19 N.W. 972, 973. Restatement, Torts § 529: "A statement in a business transaction which, while stating the truth so far as it goes, the maker knows or believes to be materially misleading because of his failure to state qualifying matter is a fraudulent misrepresentation."

takes a document for its safekeeping file for a customer and issues a receipt describing the document, warrant or have a duty to find out about the genuineness thereof?

It would be somewhat surprising to find an affirmative answer to this question. As noted above, Fidelity made but a nominal charge for this safekeeping facility and that nominal charge hardly covered its expenses. It quite obviously was not voluntarily getting itself into a position of warranting the genuineness of documents left with it for safekeeping. An analogy to this situation can be found in letter of credit cases. A bank which pays in good faith against a forged bill of lading can recover from the customer for whom it issued the letter. The bank is under no duty to investigate the genuineness of the shipping document. A leading case is *Brown* v. *C. Rosenstein Co.*, 1923, 120 Misc. 787, 200 N.Y.S. 491, affirmed without opinion 1st Dept., 1924, 208 App. Div. 799, 203 N.Y.S. 922. See McCurdy, Commercial Letters of Credit, 35 Harv.L.Rev. 715, 734—735 (1922); and Ward and Harfield, Bank Credits and Acceptances 54—55, 93—98 (3d ed. 1948).

We have another analogy in warehouse cases. In Dean v. Driggs, 1893, 137 N.Y. 274, 33 N.E. 326, 19 L.R.A. 302, a warehouseman gave a receipt for " 'fifteen hundred barrels Portland cement.' " The court held the warehouseman not liable to the endorsee of the receipts because the barrels contained a worthless substance. Judge Peckham said: "In its very nature it seems to me plain that no warranty as to contents can reasonably be implied under these circumstances from the use of such language as these receipts contain." 137 N.Y. at page 282, 33 N.E. at page 328. See also Hale v. Milwaukee Dock Co., 1878, 23 Wis. 276. Later cases

of this sort are lacking because of the custom of inserting language such as "said to contain" and "contents unknown" in documents of title. See 2 Williston on Sales 582—583 (Rev.ed.1948).

[8] We think this is right. We cannot think that either the giver of such a receipt as Fidelity issued here or the person who gets it expects the bailee for safekeeping to warrant the genuineness of the warehouse receipts or to stir about and investigate their validity. It would be easy enough for the issuer of such a receipt to make it read in terms of "documents purporting to be warehouse receipts for whisky and bearing what purports to be the signatures of certain officers," but we do not think that documents issued by the thousands in everyday business, as such things as these must be, must hedge every statement made with the supercaution of a corporate mortgage. Fidelity is not liable either as a warrantor nor as one who had a duty to investigate and failed to perform it.[10]

The above discussion covers both the liability of the defendant as a "seller" under the Securities Act and also, we think, common law liability in the nature of deceit or for negligence in the use of language.

[9] There is also a point made concerning the reference to collateral in the drafts drawn by PAC upon Zanesville.

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[10] Note that the Uniform Commercial Code specifically limits the warranties of a collecting bank as to documents: "A collecting bank or other intermediary known to be entrusted with documents on behalf of another or with collection of a draft or other claim against delivery of documents warrants by such delivery of the documents only its own good faith and authority. This rule applies even though the intermediary has purchased or made advances against the claim or draft to be collected." Purdon's Pa. Stat.Ann. tit. 12A, § 7-508.

For instance, the draft of July 21, 1950, for $19,000, after the usual date, direction to pay, amount, name of drawee, and so on has this clause: "$19,000 Alexander Young Distilling Co. Collateral Note No. SY-274 dated 7/21/50—due 8/7/50, together with Fidelity-Philadelphia Trust Co. Safekeeping Receipt covering the collateral as fully described on the face of the note." Does that reference make the endorser (that is, Fidelity) a guarantor of the genuineness either of the note or the warehouse receipts which are collateral for the note? This question was raised and decided clearly in the negative in Hubbard Bros. & Co. v. Southern Pac. Co., 5 Cir., 1919, 256 F. 761. To the same effect is the King's Bench decision Guaranty Trust Company of New York v. Hannay & Co., [1918] 2 K.B. 623. See also, discussing the problem, Note, 32 Harv.L.Rev. 560 (1919). We agree with those decisions.

What has been said takes care, either directly or by necessary inference, of the case made by the plaintiff. It has been thoroughly and competently presented for both sides, but we think the defendant should win and that the decision of the lower court was right.

The judgment of the district court will be affirmed.